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ONTARIO
SECURITIES
COMMISSION

TASK FORCE ON SMALL BUSINESS FINANCING

FINAL REPORT

OCTOBER 1996

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PREFACE

Few public policy issues have proven as difficult for securities regulators to address meaningfully over the years than those related to small business financing. There are a number of probable causes, including the following.

First is the inherent tension (often exaggerated by those seeking to "scapegoat" securities regulation for economic costs not imposed by it) between some of the traditional regulatory instruments utilized to achieve investor protection objectives and the otherwise complementary goal of fostering capital formation.

A second, related difficulty is the fact that small business financing (in contrast to most securities regulation) tends to enjoy a measure of political currency. As a result, issues often assume an ideological dimension. This in turn often makes it difficult to distinguish attachment to rhetorical conventions from substantive analysis.

A third issue is the universal tendency to adhere to the status quo. This is particularly the case where legislation serves as a basis for policy, inasmuch as such regulatory frameworks tend to be accompanied by a commitment to policy which remains stable over long periods of time. Achieving rule-making authority for the Commission was a direct response to this concern.

The Task Force on Small Business Financing was an attempt to break out of these constraints. Its inception assumed and coincided with a number of other strategic initiatives undertaken by the Commission during the last several years, including that which ultimately provided the Commission with rule-making authority and an obligation to reformulate existing policy instruments, as well as an internal restructuring which has driven us to re-examine most core processes. Other related initiatives include work undertaken with and through The Toronto Stock Exchange to examine issues relating to civil liability for continuous disclosure and the efficacy of the regulatory framework governing the Canadian Dealing Network.

In anticipation of these developments, the Commission was fortunate to be able to call upon the distinguished and diverse experience and insights of members of the Task Force, who have been singularly generous in their commitment to this undertaking.

As was noted in its interim report, the Task Force determined not to address certain issues being considered by others or those relating to the "closed system" generally. Rather than advance wholesale proposals for change, the Task Force chose to frame issues in ways which lend themselves to implementation in smaller steps. Bounded by these self-imposed parameters, the Task Force has been thorough, thoughtful and creative in their consultations, deliberations and interim and final recommendations. While some of its recommendations are likely to stimulate vigorous debate amongst policy makers, the Task Force has eschewed dogma and cosmetics and instead focussed on proposals that are intended to make a practical difference to issuers and investors.

The result is a set of policy proposals which, taken in isolation, prescribe incremental, but bold, steps to modify the regulatory framework and facilitate small business financing. Viewed in a broader context, the Task Force's proposals suggest a new direction for securities regulation; one that places less emphasis on "merit" regulation (ie. that aspect of regulation where securities regulators are deciding what is allowed rather than leaving the choice to informed consumers with appropriate remedies or to markets). Examples include the Task Force's recommendations with respect to future oriented financial information, escrow requirements and hold periods. In this sense, the Task Force's work may have relevance well beyond its immediate focus.

The Commission deliberately refrained from playing an normative role in the Task Force's deliberations and has yet to formally consider its report and recommendations. It is clear, however, that the quality of the report will assure its careful review by the Commission and others.

In the meanwhile, the Commission is grateful to the members of the Task Force and those who have assisted it, both directly and through the public comment process. The Commission is particularly appreciative of the efforts of Neill May, who acted as Secretary to the Task Force, and Craig Wright, who helped coordinate the Task Force's deliberations while seconded to the Commission and volunteered to assist in seeing the process to its conclusion long after returning to his law firm, as well as those of Susan McCallum, who shared with the Task Force her considerable experience and assisted it in identifying and analyzing the issues it chose to address. Their efforts and those of the Task Force have yielded significant proposals for regulators to reflect upon and respond to.

Ed Waitzer,
Chair of the Ontario Securities Commission

ONTARIO SECURITIES COMMISSION

TASK FORCE ON SMALL BUSINESS FINANCING

TASK FORCE MEMBERS:

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The Task Force would also like to acknowledge the assistance of Ram Ramachandran, Associate Chief Accountant of the Ontario Securities Commission, John Mountain, Vice President, Regulation of the Investment Funds Institute of Canada, Thomas I. A. Allen, Q.C., Chairman of The Toronto Stock Exchange Committee on Corporate Disclosure and in particular that of Craig Wright, partner at Osler, Hoskin & Harcourt.

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I. EXECUTIVE SUMMARY

A. Highlights

This is the final report (the "Report") of the Ontario Securities Commission Task Force on Small Business Financing (the "Task Force"), containing the Task Force's recommendations (the "Recommendations") to facilitate equity financing for small and medium sized business enterprises (referred to in the Report as "SMEs"). The Recommendations of the Task Force will, if implemented, simplify the methods by which equity capital can be raised by SMEs in both the private placement as well as the public markets. On the private placement side, the Task Force has recommended significant revisions to the prospectus and registration exemptions typically available to SMEs. Those Recommendations include replacing a number of existing prospectus and registration exemptions (such as the "private company", "seed capital" and "$150,000" exemptions) with two new exemptions:

- a "closely-held business issuer" exemption for trades in securities of issuers with 25 or fewer securityholders (exclusive of employees, certain former employees and "accredited investors", as described below). Issuers would be permitted to raise up to $3,000,000 in reliance on this exemption. Issuers would generally be required to provide a short generic document to investors under the closely-held business issuer exemption explaining what to look for when assessing a small business investment; and

- an "accredited investor" exemption which would permit issuers to raise any amount from any person or company who meets specified qualification criteria. Accredited investors would include banks, loan and trust companies, insurance companies, the federal, provincial and municipal governments and their agencies and international counterparts, mutual funds and non-redeemable funds who distribute securities under a prospectus or to accredited investors, certain pension funds and charities, individuals with a net worth (together with that individual's spouse) of not less than $1,000,000, persons having (together with their spouse) in the last two years and expecting in the next year a net income of not less than $200,000 individually or $300,000 as a couple, corporations, and other entities having net assets of at least $5,000,000, directors, officers, and promoters of an issuer and the issuer's controlling shareholders. Issuers would not be required to provide an offering memorandum or other disclosure document to an accredited investor.

The Task Force has also recommended the creation of a registration exemption for investment matching services whose clientele is limited to accredited investors.

On the public financing side, the Recommendations include:

- the creation of a new "small business prospectus form" with a question and answer format and disclosure requirements specifically tailored to SMEs which will be easier for the issuer to produce and the investor to understand;
- revisions to the pre-marketing rules to allow SMEs to "test the waters" prior to filing a preliminary prospectus;
- a simplification and liberalization of the escrow requirements; and
- an elimination of statutory civil liability for underwriters involved in public offerings by SMEs.

There are a number of issues very relevant to SME equity capital financing which are not specifically addressed in the Report. Certain of those issues, such as the regulation of markets for SMEs' securities and issues relating to civil liability for continuous disclosure, are being addressed by other parties. Other issues, such as those relating to the "closed system", are beyond the mandate of the Task Force.

The Report is the culmination of a process commenced by the Task Force in June, 1994. After an initial consultation and deliberation process, the Task Force released proposals for public consideration and comment in June, 1995. The Task Force received a large number of very helpful comments from interested parties, which it reviewed, carefully considered and relied upon in preparing the Recommendations set forth in this Report.

The Task Force believes that it is essential to understand the reasons for the Recommendations in order to fairly assess their merits. Detailed descriptions of the Recommendations, which are outlined in the executive summary to the Report, are set forth in the main body of the Report.

B. Overview

1. The Task Force was established in June of 1994. The creation of the Task Force by the Ontario Securities Commission (the "Commission" or the "OSC") complemented the provincial government's objective of improving access to capital for growing businesses. The mandate of the Task Force was to review, and make recommendations in respect of, the

Ontario legislative and regulatory framework governing the raising of equity capital by SMEs from sources other than governments and financial institutions.

2. The focus of the Task Force's mandate has been on the regulatory framework for small business equity investments: improving the comprehensibility and utility of that framework to market participants, eliminating regulatory costs which are disproportionate to the significance of the underlying regulatory objective, and ultimately improving the efficacy of the regulatory scheme. The reform of securities regulation will not automatically have a significant impact on the SME equity market. We recognize that the level of SME investment is more directly impacted by, among other things, the number of willing SME equity investors (which is in turn affected by the state of the economy and the markets and by direct incentives such as income tax credits) and by the adequacy of distribution channels for small offerings. It was not within the Task Force's mandate to address such other constraints on the ability of SMEs to raise equity financing. Our goal has been to ensure, without compromising the fundamental objective of investor protection, that the regulatory regime facilitates SME equity financing and does not impose unjustifiable impediments to such activity.

3. In June, 1995 the Task Force released a proposal for comment (the "Proposal for Comment"), in order to focus and encourage public discussion and comment on the securities regulatory framework governing SME equity capital formation. The Task Force encouraged interested parties, and in particular entrepreneurs and investors, to comment on the practicality and desirability of the proposals. The Task Force had high expectations for the comment process, which expectations were exceeded both in terms of the number and helpfulness of the comments received (a complete list of the comments received is set forth in Appendix A to this Report). The Task Force is extremely grateful for the very thoughtful responses and comments, and is encouraged by the level of interest in the subject of SME capital formation. The Task Force could not have completed this Report without the benefit of and the assistance provided by the comments received.

4. In preparing this Report, the Task Force reviewed and carefully considered the comments received in response to the Proposal for Comment. The Task Force also continued to review the various initiatives to facilitate equity capital financing of SMEs proposed and, in certain cases, implemented in other jurisdictions. The process also involved continuing consultation with various consultants and qualified commentators. Again, we are very grateful to all those who have participated in the process.

5. This Report has been prepared using the same format as, and containing much of the same background information (updated where appropriate) as set forth in, the Proposal for

Comment, for continuity and so that this Report may stand as a comprehensive guide to the Task Force's deliberations and conclusions.

6. The Commission has neither reviewed nor endorsed the Task Force's Recommendations as described in this Report. It is our understanding that the Commission intends to carefully consider the Task Force's Recommendations. The Commission may determine to adopt or pursue implementation of some, all or none of the Task Force's Recommendations, or that some of the issues addressed or Recommendations made require further study.

C. What is an SME?

1. There is no common standard for defining SMEs. SMEs are variously defined by reference to their revenues, assets, debt facilities, length of operating history, ownership structure and/or number of employees. General references to SMEs in the Report refer to enterprises which are generally of the type or reflect characteristics of SMEs under various regulatory and other definitions listed in the Report and which are commonly referred to and thought of as small and medium-sized enterprises. For the purposes of the new small business prospectus form recommended by the Task Force, it is proposed that SMEs be defined as enterprises with (i) not more than $10 million in gross revenues in the most recently completed financial year; and (ii) market capitalization (calculated on a fully diluted basis prior to the proposed offering) of not more than $35 million.

2. The selection of the $10 million in revenues ceiling in defining SMEs reflects the Task Force's view that gross revenues are the best vehicle for measurement of the appropriate size of enterprise in this context because, among other reasons, figures such as income and equity may be minimal even for entities of considerable size.

3. The revenue test has been supplemented by a market capitalization test to ensure that issuers with large market capitalizations but no significant revenues (such as development stage "high tech" or exploration stage resource issuers), which would rarely be considered to be SMEs (and should not, in our view, be so considered), are excluded. The Task Force believes that tailoring the thresholds on an industry-by-industry basis would complicate the application of the Task Force's Recommendations and undermine the objective of comprehensible regulation.

D. Guiding Principles

1. The Task Force, in an effort to enhance consistency of its analysis and to foster comprehension of its outlook and approach, has developed a list of guiding principles which underlie its Recommendations. These guiding principles are as follows:

A. The methods by which SME equity capital may be raised should be easy to use and easy to understand.

B. The regulatory framework governing SME capital formation should assist legitimate SME financing activities and the participants in that marketplace.

C. The regulatory regime governing SME capital formation should both balance SMEs' capital formation needs and the investor protection and other objectives of the regulatory regime and be proportionate in scope and effect to the significance of the regulatory objective(s) sought to be realized.

D. Reform of the securities regulatory framework to facilitate SME equity capital formation should be guided by considerations of business practicality rather than legal theory.

E. The Task Force's proposed reforms should, to the greatest extent possible, be focused upon, and limited in application to, issues relating to SME equity capital formation.

E. Harmonization

1. The Task Force recognizes (and the point was emphasized in a number of comment letters received) that one of the primary aims of any recommendations to reform the Ontario securities regulatory regime should be the increased harmonization of Canadian provincial and territorial securities regulatory requirements. However, while harmonization is undeniably desirable it is not an end in and of itself, and its benefits must be weighed against the benefits of, and it should not automatically stand in the way of, needed reform. The Task Force has reviewed the regulatory regimes in place in other Canadian jurisdictions, with particular attention to the reforms recently proposed and/or implemented in certain of those jurisdictions, and has developed recommendations which we believe to be in the best interests of SME capital formation.

2. We are also of the view that, notwithstanding the ever-increasing globalization of securities markets, SMEs are frequently financed on a local or regional basis, and there are material differences between the equity marketplaces in different regions in Canada relating to different investment landscapes and cultures, and to differences in industry base, economy size and nature of market participants, among other things. Consequently, harmonization of the securities regulatory regime which impacts SME financing, while desirable, is less critical.

3. While inter-jurisdictional variations in regulatory requirements may have effects upon the location of business activity, it is by no means the Task Force's intention that reform of Ontario's regulatory framework would have any competitive impacts.

F. Context

1. The Task Force has focused its analysis on issues relating to equity capital formation, primarily because of the general impression that sources of what is commonly referred to as debt capital appear to be more numerous and readily accessible by SMEs and because the supply of such capital is less directly impacted by the existing securities regulatory framework. This approach is consistent with the Task Force's view of the fundamental importance of equity capital to SMEs, particularly because, although debt capital may be more accessible to SMEs, limited cash flows for start-up or developing enterprises often make fixed payment schedules inappropriate and unmanageable and SMEs often lack tangible assets to secure debt financing.

2. There are a number of inter-related practical constraints to the raising of SME equity capital, including:

(i) the relative scarcity of equity capital financing deals at the low end of the market, generally in the range from $50,000 or $100,000 to $1,000,000;

(ii) "informational asymmetry", whereby insiders of SMEs (particularly in the case of high tech enterprises) are much better informed than outside investors about the quality and potential of the business, while potential investors (particularly venture capitalists) are generally much better informed about the financing alternatives available to SMEs than are the principals of SMEs;

(iii) the perception that SMEs may be unable to generate the high returns required by investors;

(iv) some entrepreneurs' negative perception of venture capital and unwillingness to share ownership;

(v) the lack of a developed distribution network in the Canadian marketplace for offerings of less than $10 million; and

(vi) matters affecting the capital markets generally, such as the comparatively high capital gains tax rates in Canada and the fact that Canadian investors have historically been more risk averse than American investors and those in certain other developed markets.

3. With respect to public financings, the costs of preparing and filing a prospectus (and related costs, such as due diligence) are considerable. Many of those costs are borne disproportionately by SMEs, principally because the direct costs are relatively higher for smaller offerings, SMEs have relatively fewer managerial resources and the time required to qualify securities under a prospectus is frequently longer for SMEs.

G. Limitations on the Scope of this Report

1. The Task Force recognizes that the financing needs of SMEs vary significantly depending upon the type of business and stage of development. In addition, SME financing is frequently a multi-stage process. This Report addresses the financing of SMEs from start-up to the stage where the Task Force considers it appropriate for the existing securities regulatory regime to apply. It does not address the issuance of securities by mutual funds or non-redeemable (i.e. closed-end) funds or for the purposes of financing a specific project such as an apartment building, office building, shopping centre, film production or other dramatic work (the "Excluded Enterprises"). It may be that many of the Recommendations, particularly those regarding the prospectus exemptions, should also be made applicable to the Excluded Enterprises, but sales of securities by Excluded Enterprises raise certain significant issues which are not the same as those the Task Force considered in its discussion of financing SMEs engaged in, for example, computer services, biotechnology, retail and wholesale sales, manufacturing, mining, and oil and gas exploration and development. In the Task Force's view these issues should be studied before a recommendation is made that the Recommendations be extended to any one or more of the Excluded Enterprises.

2. The Task Force has not considered the impact of the Recommendations on, or the need for reform with respect to the financing activities of, non-SME entities; that analysis should be undertaken in a different forum, and was beyond the Task Force's mandate. Nevertheless, the Task Force recognizes that certain of the Recommendations could be made applicable to the financing activities of larger, developed enterprises which do not qualify as SMEs, and the Task Force believes that many of the principles and specific recommendations are equally applicable to, and may well be of benefit if applied in respect of, non-SMEs. There is obvious merit in a securities regulatory regime which addresses the problems of both SMEs and non-SMEs alike.

3. There are a number of issues relevant to SME equity capital financing which are discussed in this Report but which, for a variety of reasons, are not the subject of specific recommendations. Those subjects include (i) issues relating to the Canadian Dealing Network ("CDN"), because The Toronto Stock Exchange (the "TSE") and the Commission are presently developing a more effective regulatory framework for CDN, (ii) issues relating to civil liability for continuous disclosure, which are being addressed by The Toronto Stock Exchange Committee on Corporate Disclosure (the "TSE Committee on Corporate Disclosure"), and (iii) issues relating to the closed system in general, which the Task Force believes are best addressed by a separate study.

H. Related Developments

1. In formulating its Recommendations, the Task Force took note of a number of recent proposals and initiatives, which are noted below. Although these proposals are still in their formative stages, any or all of them may ultimately have a significant impact on the Recommendations.

2. Recently, the TSE, The Montreal Exchange (the "ME"), the Alberta Stock Exchange (the "ASE"), the Vancouver Stock Exchange (the "VSE") and the Investment Dealers Association of Canada announced the formation of a twelve member panel to review and consider the adequacy of regulatory requirements concerning conflicts of interest faced by member firms financing emerging companies in Canada. Although the focus of this group's review differs significantly from that of the Task Force, its deliberations and ultimate recommendations, because they involve the raising of equity capital by SMEs, may have some impact on the implementation of the Recommendations.

3. A wide ranging report was recently published by the United States Securities and Exchange Committee Advisory Committee on Capital Formation and Regulatory Processes.

This report recommends that the Securities and Exchange Commission (the "SEC") move away from a transaction-based framework for the registration of securities offerings to an issuer-based registration system. Over the years both the SEC and Canadian securities regulatory authorities have been gradually moving towards an issuer-based system, but in both Canada and the United States the theoretical concept of transaction-based disclosure remains a fundamental premise of the system. No doubt Canadian securities regulators will follow with interest the debate which emanates from the advisory committee's report. Although the Recommendations do not specifically address the raising of equity capital by SMEs in a framework where the theoretical model of issuer-related rather than transaction-specific disclosure prevails, the Recommendations, particularly those related to exempt offerings, are compatible with such a system.

4. The electronic document filing system called System for Electronic Analysis and Retrieval ("SEDAR") (discussed in part V.D of this Report) is about to become operational. The Canadian Securities Administrators (the "CSA") recently announced that the first mandatory continuous disclosure filings under the SEDAR will be made in January, 1997 (rather than October, 1996, as previously announced). The Task Force looks forward to the successful implementation of this system which should assist in the dissemination of timely, complete and accurate information. Such a system is potentially of greatest help in making information available regarding smaller issuers who are less likely to be widely followed by analysts and the financial press. By increasing access to information concerning SMEs who are or are about to become reporting issuers, SEDAR should positively impact the ability of SMEs to raise equity capital.

5. In December, 1995, the TSE published the interim report of the TSE Committee on Corporate Disclosure, and the Task Force expects the final report to be published soon. Specific reference is made to the work of the TSE Committee on Corporate Disclosure in Part V.F of this Report.

6. Proposals to revise the present regulatory requirements relating to reverse take-over bids have been under consideration for some time, and the Task Force understands that they are likely to be published for comment soon. In the Task Force's view, the implementation of comprehensive disclosure requirements for reverse take-overs is likely to increase the need for the implementation of its Recommendations, particularly those directly related to public offerings of securities of SMEs. Further reference is made to reverse take-over bids in Part VIII.C of this Report.

I. Focus of Report

1. The focus of the Report is on the legislative and regulatory requirements which impact most directly on, and therefore may impede, SME equity capital financing. Those elements are as follows:

A. Exemptions from the prospectus and registration requirements of the *Securities Act* (Ontario) (the *"Securities Act"*).

B. Offerings of securities by SMEs by way of prospectus.

C. The escrow requirements prescribed by OSC Policy Statement Nos. 5.2 ("OSC Policy 5.2") and 5.9 ("OSC Policy 5.9").

D. The prescriptions governing disclosure of future oriented financial information ("FOFI") set forth in National Policy Statement No. 48 ("National Policy 48") of the CSA.

E. The statutory civil liability imposed on registrants involved in the qualification and sale of securities under a prospectus and the requirements concerning the involvement of a registrant in exempt market distributions.

F. Issues concerning the resale of securities privately placed in reliance upon an exemption from the prospectus requirements of the *Securities Act*.

The Report also briefly addresses SME-specific issues relating to secondary market trading and the need for separate sectoral strategies.

The Task Force's recommendations for reform are outlined below. **This outline is a summary only. More detailed descriptions of the Recommendations and the reasons therefor are set forth in the main body of the Report. The Task Force believes that it is essential to understand the reasons for the Recommendations in order to fairly assess their merits.**

J. Exempt Offerings

1. We recommend the creation of a new prospectus exemption for trades in securities of "closely-held business issuers", with a parallel registration exemption (subject to universal

registration). "Closely-held business issuers" would be defined as issuers with twenty-five or fewer securityholders (after giving effect to the proposed financing but exclusive of both accredited investors (as described below) and employees and certain former employees of the issuer and its affiliates. The lifetime aggregate amount of securities sold under this exemption by an issuer (and related issuers) would be limited to $3 million. Promoters would be entitled to rely on this exemption only once in any given twelve month period.

2. We recommend that SME issuers with more than five securityholders (including employees) be required to provide a generic information statement about the nature of SME investments to each investor (other than accredited investors) to whom securities are sold in reliance upon the closely-held business issuer exemption not less than four business days prior to the investment.

3. We recommend the establishment of a new exemption from the prospectus and registration requirements of the *Securities Act* for a class of "accredited investors", which class shall include (i) a list of prescribed institutions, (ii) corporations, limited partnerships or other entities having $5 million or more in assets, (iii) persons with a net worth (together with their spouse) of not less than $1 million or net income over a specified threshold and (iv) the issuer's management. There would be no limitation on the number of solicitations, number of purchasers, or on the number of times the exemption could be relied upon. Generally, no disclosure materials would be required to be provided to accredited investors.

4. We recommend that the existing private company, prescribed institution, exempt purchaser, $150,000, seed capital and government incentive securities exemptions and related provisions be eliminated.[1]

5. In addition, the Task Force recommends generally that the liberalization of securities marketing reflected in Draft National Policy Statement No. 43 of the CSA ("Draft National Policy 43) should be equally applicable to exempt offerings made to accredited investors. The growing variety of marketing media may facilitate SME capital formation and should be accessible to SMEs seeking to raise equity capital without requiring the preparation and delivery of an offering memorandum with prospectus-like disclosure (thereby undermining the benefits of the prospectus exemption).

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[1] Specifically, we propose that clauses 35(2)10 and 72(1)(a), (c), (d), (l), and (p) and subsection 72(2) of the *Securities Act* and subsections 14(b), (c), (d) and (f) and sections 27, 28, 31 and 32 of the Regulation (the "Regulation") under the Securities Act be eliminated.

6. To help bridge the gap between users and suppliers of SME equity capital in the exempt market the Task Force recommends that investment matching services that limit their clientele to accredited investors be exempt from registration. The Task Force has concluded that investment matching services which involve non-accredited investors should be examined and, if appropriate, exempted by the Commission on a case-by-case basis.

K. Small Public Offerings

1. We recommend the development and adoption of a revised prospectus form (the "Small Business Prospectus Form") which utilizes a simplified question and answer format and includes comprehensive instructions concerning completion of the form. The disclosure requirements of the new form would be oriented to issues relevant to SMEs and/or to investors in SMEs. The Small Business Prospectus Form could only be used by an issuer with not more than $10 million in gross revenues in its most recently completed financial year and with market capitalization (calculated on a fully-diluted basis prior to the proposed offering) of not more than $35 million. There would be no limit on the amount of money which could be raised using the Small Business Prospectus Form.

2. We recommend that the rule against pre-marketing be modified to permit issuers whose securities are not publicly traded to test the market for their securities prior to the filing of a preliminary prospectus.

3. The Task Force recommends that auditors be liable only for their proportionate share of damages awarded to a plaintiff in a statutory civil action for misrepresentation in an offering document prepared using the Small Business Prospectus Form.

L. Future Oriented Financial Information

1. The Task Force understands that staff of various Canadian securities regulatory authorities are presently considering changes to National Policy 48; accordingly, the Task Force is not proposing specific changes to the FOFI regime applicable to SMEs at this time. Generally, however, the Task Force believes that substantive restrictions (such as an audit requirement or limitations on the use of ranges) should not be imposed on FOFI used in connection with offerings made under the closely-held business issuer or accredited investor exemptions. Disclosure regarding the considerations in assessing FOFI should be included in the generic information statement referred to in paragraph J.2 above if FOFI is provided.

2. The Task Force believes that FOFI is generally more important for SMEs than for larger enterprises. At the same time, the requirements of National Policy 48 impose a relatively greater burden on SMEs since SMEs will often have more difficulty in preparing FOFI and auditing the FOFI will be more time-consuming and costly, if it can be audited at all. As a result, the Task Force believes that reform may be necessary. More frequent use of ranges for FOFI by SMEs might mitigate the above problems and also result in more appropriate FOFI being presented. Consideration should be given to developing approaches to FOFI that would not require it to be audited and to allow greater use of projections (as opposed to forecasts). Any reform of the FOFI requirements should balance: (i) the importance of FOFI to SME investors and the consequential need to facilitate FOFI presentation; (ii) the need to impose discipline on unreasonable FOFI by means that do not present insurmountable obstacles to SME issuers; (iii) the characteristics of SME issuers that warrant flexibility in the types of FOFI permitted to be disclosed, particularly with respect to the use of projections; and (iv) the propriety of communicating the nature of FOFI and the difficulty in projecting SMEs' future performance to investors.

M. Escrow Requirements

1. The regulatory escrow requirements should be changed in the following respects:

   A. The credit for net tangible assets should be eliminated from the calculation of the number of shares subject to escrow requirements, and clause 38(1)3 of the Regulation should be repealed.

   B. The escrow release requirements should be standardized for all issuers, to provide that one-third of the shares are free from escrow, one-third are to be released nine months after the closing date of the offering, and the remaining one-third are to be released on the later of eighteen months after the closing date and one week after the filing of the issuer's first post-offering audited annual financial statements.

In addition, for the reasons discussed below, we recommend the repeal of sector-specific regulatory regimes, including OSC Policy 5.2 which includes escrow requirements for junior natural resource issuers.

N. Registration Requirements

1. We recommend that the requirement that any underwriter involved in a prospectus offering sign a certificate in a prospectus stating that to the best of its knowledge, information and belief, the prospectus contains no misrepresentation, which is the source of underwriters' statutory civil liability under the *Securities Act*, not apply to SME prospectuses.

2. We further recommend that, in the context of exempt market transactions, the registration requirement should be eliminated for SMEs and their officers and directors.

O. Hold Periods

1. The Task Force recommends that all previously issued securities should be permitted to be qualified for distribution under a prospectus.

2. An overall reassessment of the closed system should be commenced by way of an OSC staff study or by another task force.

P. Secondary Market Trading

1. The Task Force believes that the attractiveness and credibility of CDN, in view of its significance to SME issuers, are very important for SME capital formation.

2. We make no specific recommendations concerning the future of CDN, nor any comments concerning recommendations made by various commentators to lower the listing requirements of the TSE or to create a second tier of trading on the TSE, as those issues are being dealt with by the TSE (subject, of course, to oversight by the OSC). Our leaving these issues to be dealt with by the TSE is not in any way based upon non-recognition of their importance to facilitating the raising of equity by SMEs. The Task Force recognizes that few investors will be interested in buying securities unless there is a reasonable prospect of profit from resale. It is because of the significance of secondary market trading activity that the Task Force felt that the issue would be best addressed by those who are primarily involved in this activity.

Q. Sectoral Strategies

1. Financing requirements for issuers under the existing regulatory regime vary to a certain extent depending on the particular issuer's industry sector. The Task Force is of the view that financing requirements should not vary based upon an issuer's industry, for two reasons. First, the Task Force believes that securities regulatory requirements should not be used to further collateral government policy initiatives. Secondly, and perhaps more importantly, the Task Force believes that in formulating securities regulatory requirements, there is no longer a need to develop sector-specific regulatory regimes. Accordingly, the Task Force proposes that sector-specific components of the existing regulatory regime be repealed.

R. Copies of the Report

1. Additional copies of this Report are available by attending in person at the offices of the Ontario Securities Commission, 8th Floor, 20 Queen Street West, Toronto, Ontario. Bulk orders can be arranged through Rowena McDougall, Ontario Securities Commission - (416) 593-8117.

II. OVERVIEW

A. The Mandate of the Task Force

This is the final report (the "Report") of the Ontario Securities Commission Task Force on Small Business Financing (the "Task Force"). The Task Force was established in June of 1994. The creation of the Task Force by the Ontario Securities Commission (the "Commission" or the "OSC") complemented the provincial government's objective of improving access to capital for growing businesses.[2] The mandate of the Task Force was to review, and make recommendations in respect of, the Ontario legislative and regulatory framework governing the raising of equity capital by small and medium-sized business enterprises (referred to in this Report as "SMEs") from sources other than governments and financial institutions.

The vital significance of SMEs to the domestic economy,[3] and the importance of equity capital in financing growth-oriented SMEs, have been widely recognized. In this context, the principal objective of the Task Force is to recommend changes to the existing regulatory scheme to facilitate equity investment in SMEs.

The focus of the Task Force's mandate has been on the regulatory framework for SME equity investments: improving the comprehensibility and utility of that framework to market participants, eliminating regulatory costs which are disproportionate to the significance of the underlying regulatory objective, and ultimately improving the efficacy of the regulatory scheme. The reform of securities regulation will not automatically have a significant impact on the SME equity market. We recognize that the level of SME investment is more directly impacted by, among other things, the number of willing SME equity investors (which is in turn affected by the state of the economy and the markets and by direct incentives such as income tax credits) and by the adequacy of distribution channels for small offerings. Our goal is to ensure, without compromising the fundamental objective of investor protection, that the regulatory regime facilitates SME equity financing and does not impose unjustifiable impediments to such activity.

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2 See 1996, Ontario Budget Speech, particularly at page 22. See also Jeffrey MacIntosh, "Legal and Institutional Barriers to Financing Innovative Enterprises in Canada", Government and Competitiveness School of Policy Studies, Queens University, October, 1994 (the "MacIntosh Paper") at pp. 3-6.

3 For a discussion of the critical role played by SMEs in the Canadian economy, reference should be made to *Small Business in Canada: Competing Through Growth* (Ottawa: Industry, Science and Technology Canada, 1990), and *Small Business in Canada: A Statistical Overview* (Ottawa: Industry Canada, 1994).

B. The Process

Issues relating to the equity capital requirements of SMEs have been addressed in a vast range of governmental and quasi-governmental reports and academic commentaries and articles, in Canada and other jurisdictions. Moreover, a wide variety of initiatives to facilitate equity capital financing of SMEs has been proposed and, in certain cases, implemented in other jurisdictions, including British Columbia, Manitoba, Nova Scotia and Quebec.[4] The Task Force has undertaken a detailed review of those materials and initiatives (a selective bibliography of the materials reviewed is attached as Appendix B).

In June, 1995, the Task Force released a proposal for comment (the "Proposal for Comment"), in order to focus and encourage public discussion and comment on the securities regulatory framework governing SME equity capital formation. The Task Force encouraged interested parties, and in particular, entrepreneurs and investors, to comment on the practicality and desirability of the proposals. The Task Force had high expectations for the comment process, which expectations were exceeded both in terms of the number and helpfulness of the comments received (a complete list of the comments received is set forth in Appendix A to this Report). The Task Force is extremely grateful for the very thoughtful responses and comments, and is encouraged by the high level of interest in the subject of SME capital formation. The Task Force could not have completed this report without the benefit and the assistance provided by the comments received. While a specific response to each comment received is beyond the scope of this Report, the Task Force wishes to emphasize that all of the comments received were carefully considered. If any suggestions made or alternatives recommended in submitted comment letters have not been adopted or responded to in this

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[4] Many reforms to facilitate SME financing have already been implemented in British Columbia. These reforms are reflected in, *inter alia*, in sections 89 and 128 of the rules promulgated by the British Columbia Securities Commission pursuant to the *Securities Act* (British Columbia), B.C. Reg. 479/95, effective January 1, 1996 (the "British Columbia Securities Rules"). Reference should also be made to the definition of "sophisticated purchaser" in section 1 and to Form 20A of the British Columbia Securities Rules. The proposed Nova Scotia reforms are described in a discussion paper released in 1994 by the Nova Scotia Securities Commission. A discussion of the issues being considered by the Quebec Securities Commission (the "QSC") is included in the QSC's December, 1993 Quinquennial Report on the Implementation of the Securities Act at pp. 56-59. A recently published companion document to the said Quinquennial Report entitled "Changing Markets: Adapting to New Issues", released in April, 1996, recommends (see paragraph 1.7, recommendation #32) the foundation of a task force to assess the feasibility of establishing an organized market for SME securities in Quebec. The proposed changes to the regulatory framework in Manitoba were published by the Manitoba Securities Commission on December 5, 1995 in a proposal entitled "Small Business Financing in Manitoba - Proposed Changes to Securities Legislation".

Report, it should not be interpreted as any lack of appreciation on the part of the Task Force.

In preparing this Report, the Task Force reviewed and carefully considered the comments received in response to the Proposal for Comment. The Task Force also continued to review the various initiatives to facilitate equity capital financing of SMEs proposed and, in certain cases, implemented in other jurisdictions. The process also involved continuing consultation with various consultants and qualified commentators. Again, we are very grateful to those who have participated in the process.

The Commission has neither reviewed nor endorsed the Task Force's recommendations (the "Recommendations") as described in this Report. It is our understanding that the Commission intends to carefully consider the Task Force's Recommendations. The Commission may determine to adopt or pursue implementation of some, all or none of the Recommendations, or that some of the issues addressed or Recommendations made require further study.

C. What is an SME?

There is no common standard for defining SMEs. SMEs are variously defined by reference to their revenues, assets, debt facilities, length of operating history, ownership structure and/or number of employees. For example, the Canadian Chamber of Commerce has defined a "small firm" as one with less than $2 million in annual sales or fewer than 100 employees, and a "medium-sized" firm as one with $2-$20 million in annual sales or 100-499 employees.[5] Statistics Canada, in its work related to SMEs, uses asset and/or employee tests: for example, for certain purposes Statistic Canada defines a small firm as one with less than $5 million in assets, and a medium-sized firm as one with between $5-$25 million in assets, and for other purposes defines a small business as a business with fewer than 50 employees and defines a medium-sized business as one with between 50 and 100 employees. The Canadian Federation of Independent Business uses a definition of fewer than 20 employees and/or a chartered bank lending facility of less than $500,000. Local Policy 3-17 of the British Columbia Securities Commission (the "BCSC"), which provides guidelines regarding obtaining a qualified consultant's technical assessment report of certain issuers and which for practical purposes defines "junior issuers" for the purposes of the British Columbia regulatory regime, requires a technical assessment report where, among other things, the issuer has been

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[5] The Canadian Chamber of Commerce (1988), *Focus 2000: Report of the Task Force on Making Investment Capital Available*, p. 18.

in business for less than three financial years or has not had net income after taxes in each of its last two financial years. In a recent study completed by The Conference Board of Canada, SMEs were defined as corporations with fewer than 100 employees and a bank borrowing facility of less than $1 million.[6] In other cases, size limitations have been tailored to specific industries; for the purposes of the new U.S. Small Business Regulatory Enforcement Act of 1996 (HR 3136),[7] the American Small Business Administration established size limitations for small business concerns in a variety of industries, in some cases based on gross revenues (with the thresholds for most industries falling around U.S. $5 million, although they range from U.S. $500,000 to U.S $20 million) and in others based on an enterprise's number of employees (with a 500 employee limitation for most industries).[8]

The report (the "Berger Report") entitled *Taking Care of Small Business* released by the House of Commons Standing Committee on Industry (commonly referred to as the "Berger Committee") in October, 1994, states as follows:

> In Canada, the definitions of a small business (following the leadership of the federal government) have traditionally been as follows:
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> - fewer than 100 employees in the manufacturing sector;
> - fewer than 50 employees in the services sector; and
> - revenues not exceeding $2 million (regardless of sector).
>
> There is however, an increasing tendency to use the 50-employee level for the manufacturing sector, and a $5 million ceiling to apply to revenues.
>
> Medium-sized firms are defined as having fewer than 500 employees.[9]

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6 Carolyn Conner, Financial Research Group, The Conference Board of Canada, "Alternative Sources of Debt Financing for Small and Medium-Sized Enterprises", March 1995.

7 Enacted as Title II to the Contract with America Advancement Act of 1996.

8 For various other definitions of SMEs, see the MacIntosh Paper at pp. 2-3.

9 Berger Report, at p.72.

Finally, two of the criteria which define the businesses in which regulated Ontario labour sponsored investment fund corporations may invest are, generally, total assets not exceeding $50 million and not more than 500 employees.[10]

General references to SMEs in this Report refer to enterprises which are generally of the type or reflect characteristics of SMEs under the definitions listed above and which are commonly referred to and thought of as small and medium-sized enterprises.

For the purposes of the new small business prospectus form recommended herein, we propose that SMEs be defined as enterprises with: (i) not more than $10 million in gross revenues in the most recently completed financial year; and (ii) market capitalization (calculated on a fully-diluted basis prior to the proposed offering of not more than $35 million). The selection of the $10 million in revenues ceiling in defining SMEs reflects our view that gross revenues are the best vehicle for measurement of the appropriate size of enterprise in this context because, among other reasons, figures such as income and equity may be minimal even for entities of considerable size. The revenue test has been supplemented by a market capitalization test to ensure that issuers with large market capitalizations but no significant revenue (such as "hi-tech" or resource issuers), which would rarely be considered to be SMEs (and should not, in our view, be considered), are excluded. The Task Force believes that tailoring the thresholds on an industry-by-industry basis would unduly complicate the application of the Task Force's Recommendations and undermine the objective of comprehensible regulation.

D. Guiding Principles

The Task Force, in an effort to enhance consistency of its analysis and to foster comprehension of its outlook and approach, has developed a list of guiding principles which underlie the Recommendations. These guiding principles are as follows:

1. The methods by which SME equity capital may be raised should be easy to use and easy to understand.

We believe that the complex and technical nature of regulation governing the issuance of securities, and the uncertainty as to the application of such regulation to typical SME capital raising transactions, add significant expense to SMEs' capital formation efforts and contribute to a significant lack of compliance with securities regulatory requirements.

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[10] Section 12 of the *Labour Sponsored Venture Capital Corporations Act* S.O. 1992, c.18.

The costs of this complexity and uncertainty are borne disproportionately by SMEs, which typically do not have relevant expertise or easy access to expert advice concerning securities regulation. Enhancing the degree of comprehension and the practical utility of the regulation of capital formation will facilitate SME financing activity in compliance with the regulatory regime while reducing the costs associated therewith.

2. The regulatory framework governing SME capital formation should assist legitimate SME financing activities and the participants in that marketplace.

Clear disclosure requirements can substantially assist entrepreneurs unfamiliar with public equity markets by guiding them to present their financing proposal to potential investors in a systematic and logical manner which in turn provides investors and advisers with the information they require in order to make informed investment decisions.

3. The regulatory regime governing SME capital formation should both balance SME capital formation needs and the investor protection and other objectives of the regulatory regime and be proportionate in scope and effect to the significance of the regulatory objective(s) sought to be realized.

The principle that regulatory objectives must be balanced among themselves and with the costs of the prescriptions implemented to fulfil those objectives is reflected in new section 2.1 of the *Securities Act*.[11] We wish to emphasize that a balancing of investor protection with SME capital formation needs does not entail an abandonment or a general compromise of the principle of investor protection. We believe that the Recommendations, if implemented, will enhance investor protection by increasing the level of compliance with

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[11] Section 2.1 of the *Securities Act* was enacted as part of the reforms implemented in response to the recommendations of the Daniels Report. The reforms codified the Commission's powers and mandate. Section 2.1 of the *Securities Act* confirms the purposes of securities regulation so as to guide the Commission in the exercise of its powers and discretion, providing, in part, as follows:

> 2.1 In pursuing the purposes of this Act, the Commission shall have regard to the following fundamental principles:
>
> 1. Balancing the importance to be given to each of the purposes of this Act may be required in specific cases.
>
> 6. Business and regulatory costs and other restrictions on the business and investment activities of market participants should be proportionate to the significance of the regulatory objectives sought to be realized.

securities regulatory requirements and by improving the disclosure provided to investors and potential investors.

SMEs seeking to raise equity capital are typically different from larger enterprises in a number of significant respects; these differences stem from a variety of factors, including the stage of development of the business, the depth of financial, managerial and other resources, the degree to which expert outside advisers are relied upon and the extent to which there are reliable historical and current records concerning operations and performance. Correspondingly, the Task Force is of the view that many suppliers of SME equity capital recognize the inherently risky nature of their investments and may be prepared to accept a lesser standard of investor protection. In effecting the balances described, and in seeking to facilitate matching of SME equity capital needs with appropriate sources of capital, recognition must be given to, and proper account must be taken of, the financing needs of SMEs, the nature of typical and legitimate SME capital formation activities and the characteristics of suppliers and users of SME equity capital. The regulatory requirements should not reflect an unnecessarily paternalistic approach and should be "cost-effective".[12]

4. **Reform of the securities regulatory framework to facilitate SME equity capital formation should be guided by considerations of business practicality rather than legal theory.**

The regulatory regime governing SME equity capital formation should be responsive to and, to the extent practicable, should address and reflect contemporary business practicalities.

5. **The Task Force's proposed reforms should, to the greatest extent possible, be focused upon, and limited in application to, issues relating to SME equity capital formation.**

We believe that recommended reforms which necessitate a reassessment of fundamental principles of securities regulation as a whole should be avoided by the Task Force where possible, as consideration by the investment community and relevant governmental and regulatory authorities of those broader issues may delay or adversely affect the likelihood of the implementation of regulatory changes needed to facilitate SME equity capital formation.

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[12] See the MacIntosh Paper at pp. 89-93.

E. Harmonization

The Task Force recognizes (and the point was emphasized in a number of comment letters received) that one of the primary aims of any recommendations to reform the Ontario securities regulatory regime should be the increased harmonization of Canadian provincial and territorial securities regulatory requirements. However, while harmonization is undeniably desirable, it is not an end in and of itself, and its benefits must be weighed against the benefits of, and it should not automatically stand in the way of needed reform. The issues concerning the formation of SME equity capital discussed in this Report have been considered in other Canadian jurisdictions and are the subject of recent changes and/or specific proposals in certain other jurisdictions, as noted above. The Task Force has reviewed the regulatory regimes in place in other Canadian jurisdictions, with particular attention to the reforms recently proposed and/or implemented in certain of those jurisdictions (many of which are not consistent with the Recommendations) and has developed recommendations which we believe to be in the best interests of SME capital formation (and to both users and suppliers of SME equity capital).

The Task Force is of the view that, notwithstanding the ever-increasing globalization of securities markets, SMEs are frequently financed on a local or regional basis, and there are material differences between the equity marketplaces in different regions in Canada relating to different investment landscapes and cultures, and to differences in industry base, economy size and nature of market participants, among other things. Consequently, harmonization of the securities regulatory regime which impacts SME financing, while desirable, may be less critical.

While inter-jurisdictional variations in regulatory requirements may have effects upon the location of business activity, it is not the Task Force's intention that reform of Ontario's regulatory framework would have any competitive impacts.

Of course, any initiatives to address SME capital formation issues on a national or multi-jurisdictional basis should be encouraged.

F. Limitations on the Scope of this Report

The Task Force recognizes that the financing needs of SMEs vary significantly depending upon the type of business and stage of development. In addition, SME financing is frequently a multi-stage process. This Report addresses the financing of SMEs from start-up to the stage where the Task Force considers it appropriate for the normal securities

regulatory regime to apply. It does not address the issuance of securities by mutual funds or non-redeemable (i.e. closed-end) funds or for the purposes of financing a specific project such as an apartment building, office building, shopping centre, film production or other dramatic work (the "Excluded Enterprises"). It may be that many of the Recommendations, particularly those regarding the prospectus exemptions, should also be made applicable to the Excluded Enterprises, but sales of securities by Excluded Enterprises raise certain significant issues which are not the same as those the Task Force considered in its discussion of financing SMEs engaged in, for example, computer services, biotechnology, retail and wholesale sales, mining, manufacturing, and oil and gas exploration and development. In the Task Force's view these issues should be studied before a recommendation is made that the Recommendations be extended to any one or more of the Excluded Enterprises.

The Task Force has not specifically considered the impact of the Recommendations on, or the need for reform with respect to the financing activities of, non-SME entities; that analysis should be undertaken in a different forum, and was beyond the Task Force's mandate. Nevertheless, the Task Force recognizes that certain of the Recommendations could be made applicable to the financing activities of larger, developed enterprises which do not qualify as SMEs, and the Task Force believes that many of the principles and specific recommendations are equally applicable to, and may well be of benefit if applied in respect of, non-SMEs. There is obvious merit in a securities regulatory regime which addresses the problems of both SMEs and non-SMEs alike.

There are a number of issues relevant to SME equity capital financing which are discussed in this Report but which, for a variety of reasons, are not the subject of specific Recommendations. Those subjects include (i) issues relating to the Canadian Dealing Network ("CDN"), because the TSE and the OSC are presently developing a more effective regulatory framework for CDN,[13] and (ii) issues relating to the closed system in general, which the Task Force believes are best addressed by a separate study.[14]

One of the Task Force's original concepts was to attempt to foster the formation of non-redeemable investment funds. One of the ways of dealing with the trade-off between investor protection and the need to finance SMEs is to create an incentive for the establishment of professionally managed funds invested in a diversified portfolio of SME securities. In this way, public investors could benefit from the advice of professional managers qualified to assess venture capital investments and from the diversification provided

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[13] See Part X of this Report.

[14] See Part IX of this Report.

by pooled funds. However, due to the increasing amount of money presently invested in labour-sponsored venture capital corporations ("LSVCCs"), the difficulties such funds have experienced in finding appropriate SME investments and existing governmental involvement in setting up community-based investment funds (such as the Canada Community Investment Plan initiative, currently undertaking its National Call for Demonstration Projects in order to identify investment facilitation services to be funded), the Task Force determined that it should concentrate its efforts on methods of facilitating direct investment. While it still believes that the concept of funds, particularly non-redeemable funds which do not involve liquidity or valuation problems and which are professionally advised or managed, could be a very significant method of creating an appropriate supply of equity capital for SMEs, the Recommendations do not specifically address this area.

G. Related Developments

In formulating its Recommendations, the Task Force took note of a number of recent proposals and initiatives, which are noted below. Although these proposals are still in their formative stages, any or all of them may ultimately have a significant impact on the Recommendations.

Recently, the TSE, The Montreal Exchange (the "ME"), the Alberta Stock Exchange (the "ASE"), the Vancouver Stock Exchange (the "VSE") and the Investment Dealers Association of Canada announced the formation of a twelve member panel to review and consider the adequacy of regulatory requirements concerning conflicts of interest faced by member firms financing emerging companies in Canada. Although the focus of this group's review differs significantly from that of the Task Force, its deliberations and ultimate recommendations, because they involve the raising of equity capital by SMEs, may have some impact on the implementation of the Recommendations.

A wide ranging report was recently published by the United States Securities and Exchange Committee Advisory Committee on Capital Formation and Regulatory Processes. This report recommends that the Securities and Exchange Commission (the "SEC") move away from a transaction-based framework for the registration of securities offerings to an issuer-based registration system. Over the years both the SEC and Canadian securities regulatory authorities have been gradually moving towards an issuer-based system, but in both Canada and the United States the theoretical concept of transaction-based disclosure remains a fundamental premise of the system. No doubt Canadian securities regulators will follow with interest the debate which emanates from the advisory committee's report. Although the Recommendations do not specifically address the raising of equity capital by SMEs in a

framework where the theoretical model of issuer-related rather than transaction-specific disclosure prevails, the Recommendations, particularly those related to exempt offerings, are compatible with such a system.

The electronic document filing system called System for Electronic Analysis and Retrieval ("SEDAR") (discussed in part V.D of this Report) is about to become operational. The Canadian Securities Administrators (the "CSA") recently announced that the first mandatory continuous disclosure filings under the SEDAR will be made in January, 1997 (rather than October, 1996, as previously announced). The Task Force looks forward to the successful implementation of this system which should assist in the dissemination of timely, complete and accurate information. Such a system is potentially of greatest help in making information available regarding smaller issuers who are less likely to be widely followed by analysts and the financial press. By increasing access to information concerning SMEs who are or are about to become reporting issuers, SEDAR should positively impact the ability of SMEs to raise equity capital.

In December, 1996, the TSE published the interim report of the TSE Committee on Corporate Disclosure, and the Task Force expects the final report to be published soon. Specific reference is made to the work of the TSE Committee on Corporate Disclosure in Part V.F of this Report.

Proposals to revise the present regulatory requirements relating to reverse take-over bids have been under consideration for some time, and the Task Force understands that they are likely to be published for comment soon. In the Task Force's view, the implementation of comprehensive disclosure requirements for reverse take-overs is likely to increase the need for the implementation of its Recommendations, particularly those directly related to public offerings of securities of SMEs. Further reference is made to reverse take-over bids in Part VIII.C of this Report.

H. Inflation

As a general matter, we recommend that all monetary amounts referred to in the Recommendations, if implemented, be reviewed on a periodic basis (for example, on a quinquennial basis) to determine whether an adjustment for inflation is necessary.

III. CONTEXT

A. Sources of SME Capital

There is a broad spectrum of potential sources of SME capital. The various sources are commonly grouped into two basic categories, equity financing and debt financing, based on the sources and attributes.

The Berger Report described above contains a detailed discussion of the various sources of debt capital accessible by SMEs.[15] What follows is a brief list of certain of those sources; for a fuller discussion of these sources reference should be made to the full text of that report.

The principal sources of debt capital to SMEs are Canada's chartered banks (approximately 90% of external SME debt financing is provided by the chartered banks, according to bank sources cited in the Berger Report[16]). As emphasized in the MacIntosh Paper,[17] there are various perceived difficulties that exist in relationships between SMEs and banks and other financial institutions, including a natural preference for lower-risk loans, the inability of such institutions to earn attractive margins on smaller-sized loans and the institutions' general unwillingness to provide financing where no tangible assets are put forward as security. Other sources of debt capital include: (i) trust and mortgage loan companies; (ii) caisses populaires; (iii) credit unions; (iv) insurance companies; (v) foreign bank subsidiaries; (vi) specialized private sector SME debt financiers; (vii) providers of leasing or assets-based financing, i.e. financing provided upon security of specified hard assets; and (viii) providers of venture capital, mezzanine financing and merchant banks.

There is also a very significant amount of government-sponsored SME financing. Examples of direct government sources of SME capital include: (i) the Federal Business Development Bank, a Crown corporation created to provide "complementary financing" (i.e. financing that would not otherwise be available) to businesses in Canada, particularly SMEs;

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15 Another detailed analysis of sources of SME debt financing for SMEs is set fourth in the March 1995 report of The Conference Board of Canada entitled "Alternative Sources of Debt Financing for Small and Medium-Sized Enterprises", supra, footnote 6.

16 Berger Report, p.9.

17 See the MacIntosh Paper at pp. 57-89. The difficulties experienced by SMEs in accessing the debt market are also discussed in Canadian Labour Market and Productivity Centre, "Access to Capital Resources in Canada", Working Paper, November, 1993 at pp. 9-13.

(ii) the Farm Credit Corporation, which has a mandate to "enhance rural Canada by providing...financial services to farming operations...including small and medium-sized businesses that are related to farming; and (iii) the Export Development Corporation, a Crown corporation offering various types of financial services to support and develop Canada's export trade. Indirect governmental support for private investments in SMEs is provided through initiatives such as the loan guarantee provided under the federal *Small Business Loans Act* and the generous federal and provincial tax incentives for investments in LSVCCs, which have become an increasingly significant source of equity financing for SMEs.[18]

The Task Force focused its analysis on issues relating to equity capital formation, primarily because of the general impression that sources of what is commonly referred to as debt capital appear to be more numerous and readily accessible by SMEs and because the supply of such capital is less directly impacted by the existing securities regulatory framework.[19] This approach is consistent with our view of the fundamental importance of equity capital to SMEs, particularly because, although debt capital may be more accessible to SMEs, limited cash flows for start-up or developing enterprises often make fixed payment schedules inappropriate and unmanageable and SMEs often lack tangible assets to secure debt financing. Accordingly, we focused on issues related to the provision of capital which bears the traditional attributes of equity capital, i.e. a residual non-recourse ownership interest, without attempting to develop a precise definition of equity capital. A number of commentators have attempted to define equity capital by reference to the level of participation by the investor in management of the enterprise; although that level of participation may generally be higher for suppliers of equity capital, we do not believe that a generally applicable distinction can be drawn based on that factor alone.

B. The SME Equity Capital Market

Identifying the Sources of SME Equity Capital

To set a framework for its discussions the Task Force identified what it considered to be the major sources of equity capital available to finance the start-up or expansion of

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18 There are two types of labour-sponsored venture capital corporations. The first is the labour-sponsored investment fund, such as Working Ventures Canada Fund Inc., sponsored by the Canadian Federation of Labour, which facilitates indirect investment in venture capital projects. The second is the labour-sponsored venture capital corporation, which makes a direct investment in a specific qualifying enterprise.

19 See the MacIntosh Paper at pp. 142-152.

SMEs with a view to determining how those sources fit into the current regulatory regime and ensuring that the Recommendations recognize the role of each of the sources. Attached as Appendix C is a chart which lists each of these sources, the provision(s) on which they may currently rely to meet the requirements of the *Securities Act* and/or the regulation thereunder (the "Regulation") and the provision(s) that would be available to them under the Recommendations.

Categorizing the Sources of SME Equity[20]

Commentators have divided the equity capital market into five or six distinct segments, as follows:

1. *"Love Money"*

The first segment is commonly referred to as "love money", which is described as the entrepreneur's own money supplemented by investments by friends, relatives and business associates. Recent statistical analysis suggest that "love money", which may be structured as debt secured by personal assets, is an extremely significant source of start-up capital for small enterprises.[21]

2. *The "Angel" Market*

The second segment of the equity capital market continuum is comprised of informal venture capitalists, or "angels". A major national study on the composition and size of the

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[20] The Berger Report referred to above summarizes the findings of the Berger Committee's study of SMEs' access to capital. The stated impetus for the Berger Committee's study was the numerous complaints made to various levels of government by SMEs who were experiencing difficulty in obtaining capital for start-up, normal operations and expansion, particularly from financial institutions. A significant portion of the Berger Committee's report addresses the equity capital market for SMEs. What follows in this Part III.B relies heavily on the Berger Report's description of existing and potential sources of SME equity capital (which in turn relied heavily on consultant Mary MacDonald's submission to the Berger Committee) and on the MacIntosh Paper, supplemented by the findings of various other commentators. For a fuller discussion of these matters, reference should be made to the full text of the Berger Report and the MacIntosh Paper.

[21] Gordon Sharwood, *"The Special Problems of the Small Deal"*, *Sharwood Report*, June 1989 and Canadian Chamber of Commerce, *Breaking Down the Barriers - Final Report of the "Aim for a Million" Project*, Ottawa, 1994.

"angel" market was completed in 1993 by Professor Alan Riding and colleagues at Carleton University.[22] The results uncovered by that study suggest that:

1. Investments in the "angel" market total approximately $500 million to $1 billion annually, and the potential pool of "angel" capital is likely substantially larger.

2. "Angel" investors tend to be highly educated, experienced at the managerial level in small business enterprises and have significant wealth and cash flow. For example, in the study noted above, Riding *et al.* found that the average annual income of an "angel" investor was approximately $175,000, and the surveyed investors had a mean net worth of over $1.3 million.

3. "Angel" investors typically learn about investment opportunities from personal contacts, networks of business associates and through active personal research and, to a lesser extent from investment matching services.[23] "Angel" investors typically conduct extremely thorough "due diligence" exercises on potential investments, and ultimately invest in less than 3% of the opportunities presented to them.

4. On average, "angel" investors invest about $100,000 annually, meeting the demands for investments ranging from $10,000 to $500,000.

5. "Angel" investors tend to hold their investments for approximately six years, and have high expectations of return commensurate with the relatively high degree of risk assumed.

6. "Angel" investors typically participate in or exercise some degree of control over management of the enterprise, through board representation, insistence on operating covenants or a shareholders' agreement, providing consulting services and/or by periodic documentary review.

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22 A. Riding, P. Dal Cin, L. Duxbury, G. Haines, R. Safrata, "Informal Investors in Canada: The Identification of Salient Characteristics", Report Submitted to the Federal Department of Industry, Science and Technology (Canada) and to the Ministry of Economic Development and Trade (Ontario), May 23, 1993.

23 See Part IV.E for a discussion of investment matching services.

3. *The Formal Venture Capital Market*

The third segment of the equity capital market continuum is comprised of formal venture capitalists, professional managers of risk capital funds, capitalized both directly and/or indirectly by institutional sources, such as governments, banks, pension funds and life insurance companies, as well as by large corporations and by individual investors encouraged by tax incentives. The report of the Berger Committee estimates that at the time of its writing in the fall of 1994, the total pool of such capital sources was approximately $3.9 billion, roughly half of which was still available for investment. Investments in the formal venture capital market are typically larger than investments in the "angel" market. Evidence suggests that in 1991 the average investment in this market was approximately $1.1 million.[24]

Evidence further suggests that while "angel" investors tend to invest at the earliest stages of business development, formal venture capitalists tend to invest at later stages, after the enterprise has completed initial product development and marketing. In the 1980's, Canada's professionally managed pools secured much of their capital from private institutional sources, comprised principally of pension funds and life insurance companies; however, some adverse investment experiences and lower than expected returns appear to have caused institutions to withdraw from the market. However, this decline in private institutional funds appears to have been more than offset by the increased activity of Canadian federal and provincial governments in the formal venture capital market (the vehicles for that activity are described in Part III.A above).

4. *The Institutional Private Placement Market*

The fourth segment of the equity capital market is the institutional private placement market. However, institutions tend not to invest directly in SMEs through the institutional private placement market. Institutional monies dedicated to venture capital investments are typically invested in the formal venture capital market by professional fund managers.

5. *The Public Equity Markets*

SMEs which reach the stage of development where a public financing may be appropriate must prepare a prospectus in order to obtain access to the fifth segment, the public equity markets.

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[24] Mary Macdonald, *Venture Capital in Canada: A Guide and Sources*, Association of Canadian Venture Capital Companies (1992).

6. *Trade Partners*

One of the most significant sources of equity for SMEs is supplier and customer credit and investment, as well as strategic partnerships.[25] Enterprises in their early stages of development typically have a small number of very significant trade relationships on which they rely to support and maintain the enterprise. Trade credit generated from these relationships can be a very important source of financing; in addition, based on their familiarity with and interest in the enterprise, customers and suppliers of SMEs may be persuaded to become equity investors.

C. Problems in Obtaining SME Capital

The MacIntosh Paper and the report of the Berger Committee identified a number of inter-related practical constraints to the raising of SME equity capital, including:

(i) the financing gap referred to by the Berger Report as the "troubling scarcity of equity capital financing deals at the low end of the market", generally in the range from $50,000 or $100,000 to $1,000,000;

(ii) "informational asymmetry", whereby insiders of SMEs (particularly in the case of high tech enterprises) are much better informed than outside investors about the quality and potential of the business, while potential investors (particularly venture capitalists) are generally much better informed about financing alternatives available to SMEs than are the principals of the SME;

(iii) the relatively high cost of small scale public financing transactions, in which the costs of due diligence, prospectus preparation, meeting continuous disclosure requirements and other costs outweigh the potential benefits;

(iv) the perception that SMEs may be unable to generate the high returns required by investors; and

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25 Gordon R. Sharwood, *"Canada - Small is Always Beautiful - But Growth is Better"*, Sharwood Report, Sharwood and Company, December, 1994.

(v) some entrepreneurs' negative perception of venture capital and unwillingness to share ownership.[26]

We believe that SMEs' opportunities and ability to raise equity capital are also seriously impacted by the lack of a developed distribution network in the Canadian marketplace for offerings of less than $10 million.[27] Unlike the United States, there has not yet developed in Canada a network of dealers specializing in smaller-scale financings. There are some Canadian dealers active in this market; however, the lack of a developed distribution system limits financing opportunities and increases the cost of financing activities.

SMEs' equity capital formation activities are also clearly affected by matters affecting the capital markets generally, such as the comparatively high capital gains tax rates in Canada and the fact that Canadian investors have historically been more risk averse than American investors and those in certain other developed markets.

With respect to public financings, the costs of preparing and filing a prospectus (and related costs, such as due diligence) are considerable. Many of these costs are borne disproportionately by SMEs, for three principal reasons.[28] First, the direct costs of issuing a prospectus are relatively higher for smaller offerings. This is the case because there is a high degree of fixed costs, which do not vary dramatically based upon the size of the offering. Moreover, underwriter commissions are typically higher for smaller (and generally higher risk) offerings. The second reason relates to the availability of managerial resources and expert advisers. The process of preparing and qualifying a prospectus, particularly where a firm is not "market ready", is a time-consuming and labour-intensive process. Given that many SMEs have limited managerial resources, the cost of diverting those resources to the offering process will typically result in greater opportunity costs. Senior management of SMEs will also typically have less relevant experience and few in-house expert advisers to facilitate the process.[29] Finally, SMEs typically experience longer delays until funds are ultimately received, because of the time spent in structuring the business to accommodate public

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26 The Canadian Chamber of Commerce survey *"Aim for a Million"* found that only 6% of the surveyed entrepreneurs considered venture capital as a significant source of start-up capital. This percentage was found to move generally in proportion to the size of the entrepreneur's business.

27 See the MacIntosh Paper at pp. 140-142.

28 See the MacIntosh Paper at pp. 41-52.

29 The costs of raising equity through a public offering under the current system, particularly the cost to the issuer in terms of management time, are examined in the March, 1995 study released by Michael Andrews of the Conference Board of Canada entitled "Initial Public Offerings by Canadian Growth Companies".

participation, in preparing and clearing a prospectus (particularly because "comment" or "deficiency" letters issued by securities regulators in respect of SME prospectuses are typically longer and more detailed as to compared to "comment" letters delivered to seasoned issuers, such that SME prospectuses will typically take longer to qualify) and in marketing the offering.

Additional costs of public financings include:

(i) underpricing, which occurs if the market price of the distributed securities rises shortly after the public offering, which is considered a cost to the issuer because it suggests that the securities could have been sold for a higher price;[30]

(ii) the costs of complying with post-offering continuous disclosure requirements; and

(iii) the loss of confidentiality and autonomy.

The Task Force recognizes that the problems encountered by SMEs in raising equity capital under the current securities regulatory regime depend on the type of business and its stage of development. Consequently, the Recommendations suggest a spectrum of provisions from an exemption suitable for raising $50,000 or less to a small issuer public offering process which should accommodate most SMEs making an initial public offering.

It is not the Task Force's intention to ensure that every SME could "tap the public markets" but rather to aim to ensure a proper matching of investors and issuers along a continuum of regulatory requirements; the nature and degree of regulatory requirements applicable in varying circumstances increases along the continuum parallel to the needs of the types of investors who would normally provide equity financing for issuers wishing to raise specified sums.

In the Task Force's view the level and manner of providing information which needs to be provided to the group of unsophisticated investors who form the target market in an initial public offering is such that the process cannot be a cost-effective way of raising less than $2-3 million.

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30 Research on the cost of underpricing is summarized in Wendy Rotenberg, "Pricing Initial Public Equity Offerings: Who Wins, Who Loses and Why?", *Canadian Investment Review*, Vol. III, no. 1, Spring 1990, pp. 17-24.

A comprehensive economic analysis and commentary upon the practical problems in obtaining equity SME capital, and potential solutions to those problems, are beyond the scope of the Task Force's mandate. Our focus, and the focus of this Report, is on the securities legislative and regulatory requirements which impact most directly on, and therefore may impede, SME equity capital financing. Those elements, which are described in detail elsewhere in this Report are as follows:

1. Exemptions from the prospectus requirements of the *Securities Act* (discussed in detail in Part IV below), particularly:

    (a) exemptions based on the identity of the purchaser, involving trades to prescribed institutions and to other specified purchasers;

    (b) exemptions based on minimum aggregate acquisition cost;

    (c) limited offering exemptions, including seed capital offerings and trades in government incentive securities; and

    (d) the exemption for trades in securities of "private companies",

    together with related registration issues including issues relating to investment matching services.

2. Offerings of securities by SMEs by way of prospectus (discussed in detail in Part V below).

3. The prescriptions governing disclosure of future oriented financial information set forth in National Policy 48 (discussed in detail in Part VI below).

4. The escrow requirements prescribed by OSC Policy 5.2 and OSC Policy 5.9 (discussed in detail in Part VII below).

5. The statutory civil liability imposed on registrants involved in the qualification and sale of securities under a prospectus and the requirements concerning the involvement of a registrant in exempt market distributions (discussed in detail in Part VIII below).

6. Issues concerning the resale of securities privately placed in reliance upon an exemption from the prospectus requirements of the *Securities Act* (discussed in detail in Part IX below).

The Report also briefly addresses SME-specific issues relating to secondary market trading (see Part X below) and the need for separate sectoral strategies (see Part XI below).

IV. EXEMPT OFFERINGS

A. Existing Regulatory Regime

The *Securities Act*, which is administered by the administrative tribunal of the Commission and its staff, reflects the OSC's overall mandate to protect investors and foster fair and efficient capital markets and confidence in the capital markets.[31] Essentially, the *Securities Act* protects investors when they are involved in purchasing securities by two main requirements: the registration requirement and, in the case of a "distribution" (which is generally defined to mean issuances of newly issued securities, securities being traded by a control block holder or certain securities initially issued in exempt transactions), the prospectus requirement. However, one of the fundamental premises of the *Securities Act* is that there are certain situations where these protections, particularly the prospectus requirement, are not necessary. Exemptions from the prospectus and registration requirements are provided either because of the nature of the purchaser or the nature of security.

In Ontario, like the United States but unlike most other Canadian provinces, the regulatory regime requires that all those persons or companies who engage in or hold themselves out as engaging in Ontario in the business of trading in securities as principal or agent must be registered with the Commission as dealers. In addition, those persons who are engaged in or who hold themselves out as engaging in the business of advising others as to the investing in, or the buying or selling of, securities must be registered as advisers. As such, the availability of the registration exemptions is severely circumscribed. There are different categories of dealers and different categories of advisers depending upon the nature of the business undertaken.

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[31] See section 1.1 of the *Securities Act*.

The Prospectus Requirement

A prospectus is a disclosure document which, under the *Securities Act*, must provide "full, true and plain" disclosure of all material facts relating to the securities which are offered. Its primary purpose is to provide accurate and comprehensive information concerning all matters relevant to a potential investor in the offered securities to enable an investor to make an informed judgment concerning the investment. A prospectus also imposes liability for inaccurate or incomplete information on the issuer and certain other interested parties.

The *Securities Act* provides that a person may not distribute a security unless a preliminary prospectus and a prospectus respecting the distribution of such security have been filed with, and receipts therefor have been obtained from, the Director (as defined in the *Securities Act*). The threshold question in determining whether a prospectus is required in respect of the trade of securities is whether the transaction involves a "distribution". The most commonly occurring types of distributions within the meaning of applicable legislation involve trades in: (i) securities which have not previously been issued; (ii) securities which form part of the holdings of a "control person" or group of persons (i.e. a person or group of persons in a position to materially affect control of the issuer); [32] and (iii) securities which were previously distributed under certain exemptions and which have not been previously distributed to the public markets. It should be noted that, for the purposes of the *Securities Act*, the term "trade" is defined very broadly to include any sale or disposition of securities for valuable consideration and any act in furtherance of a trade.

The process of distributing securities under a prospectus requires the filing of a preliminary prospectus and, following a "waiting period", the filing of a final prospectus. The preliminary prospectus is intended to be the sole document containing information about the distribution of a security provided to investors during the "waiting period". The preliminary prospectus is required to contain disclosure of all items listed in the relevant prospectus form, together with information concerning all other relevant material facts. In a conventional prospectus offering, the preliminary prospectus does not contain information concerning the price of the securities being offered or any information related to the price, since pricing may be affected by changes in market conditions during the "waiting period". When the preliminary prospectus is complete it is filed, together with all other required ancillary documents, with the OSC. A receipt is issued upon filing of a preliminary prospectus

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[32] The definition of "distribution" in the *Securities Act* states that any holding of any person, company or combination of persons or companies holding more than 20% of the outstanding voting securities of an issuer shall, in the absence of evidence to the contrary, be deemed to affect materially the control of that issuer. See subsection 1(1) of the *Securities Act*.

package, after which staff of the Commission will commence its review of the substantive disclosure and the "waiting period" commences. Selling or marketing activities during the "waiting period" are circumscribed, as discussed in Part V.C below. When the OSC's review process is complete, a "comment letter" or "deficiency letter" will be provided, listing the regulator's areas of concern with respect to the disclosure given. Once the deficiencies have been resolved, the final prospectus and ancillary documents can be filed and a receipt obtained therefor. It is only after the final prospectus has been receipted that the securities qualified thereby may be sold. The underwriter must send the purchaser or his agent a copy of the prospectus before or within two business days of entering into a written confirmation of a sale of securities. The purchaser of the securities sold is then entitled to a two-day "cooling-off period", during which the purchaser may elect to withdraw from its obligation to buy the securities.

Section 130 of the *Securities Act* expands the scope of common law liability that would attach to a misrepresentation in a prospectus by providing that where a prospectus contains a misrepresentation,[33] then a purchaser of securities under the prospectus has a right of action for damages against: (i) the issuer or selling securityholder on whose behalf the distribution is made; (ii) each underwriter[34] of the securities who participated in the distribution and who was therefore required to sign a certificate that to the best of its knowledge, information and belief, the prospectus contains, full, true and plain disclosure; (iii) every director of the issuer at the time the prospectus was filed; (iv) every person or company who consented to their report, opinion or statement being reproduced or summarized in the prospectus but only with respect to misrepresentations in such reports, opinions or

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33 "Misrepresentation" is defined in subsection 1(1) of the *Securities Act* to mean (a) an untrue statement of material fact, or (b) an omission to state a material fact that is required to be stated or that is necessary to make a statement not misleading in the light of the circumstances in which it was made.

34 The term "underwriter" is defined in subsection 1(1) of the *Securities Act* to mean, subject to certain specified exceptions, the following:

> "underwriter" means that person or company who, as principal, agrees to purchase securities with a view to distribution or who, as agent, offers for sale or sells securities in connection with a distribution and includes a person or company who has a direct or indirect participation in any such distribution...

Because subsection 59(1) of the *Securities Act* states that "where there is an underwriter that underwriter must sign a prospectus certificate, the Commission has taken the view that the legislation does not require an underwriter to be involved in a prospectus offering; the legislation is interpreted as requiring only that any underwriter(s) who are involved must sign the prescribed form of prospectus certificate.

statements; and (v) every other person who signed the prospectus;[35] alternatively, where the purchaser purchased the security directly from the issuer, selling securityholder or underwriter, the purchaser may elect to rescind the purchase. A "due diligence defence" is available to all parties except the issuer or selling securityholder, which provides that a party will not be liable unless it failed to conduct such reasonable investigation so as to provide reasonable grounds for a belief that there had been no misrepresentation. The availability of the "due diligence" defence compels underwriters to review the business and affairs of an issuer in some detail so as to reasonably satisfy themselves that such issuer's prospectus is accurate and complete.

Liability under section 130 of the *Securities Act* is joint and several, with a right of contribution except where contribution is deemed to be not just and equitable. In addition, statutory liability is capped at the amount of gross proceeds of the offering and a defendant is not liable for damages to the extent that such defendant can prove that the damages do not represent the depreciation in value of the purchased security as a result of the misrepresentation relied upon.

The Registration Requirement

The *Securities Act* requires that persons or companies who "trade" securities or act as underwriters or securities advisers be registered with the OSC. The registration requirements seek to ensure that participants in the securities trading industry are honest, knowledgeable and likely to remain financially solvent, that the impact of any insolvency of such party on public clients is minimized, and that each such party will conduct its activities with integrity and with its clients' interests as the foremost consideration. As such, the applicable legislation imposes conditions of registration relating to matters such as minimum net free capital, bonding and insurance, record-keeping and reporting, business procedures and proper supervision of trading activities. The objectives of the registration requirements are also reflected in the "know your client" rule, which requires registrants to make inquiries as to clients' creditworthiness, investment needs and objectives, and to consider the suitability of transactions to an individual client. The registration rules also contain proficiency requirements which require that registrants have specified educational and other qualifications.

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35 Other persons who might sign a prospectus include promoters of the issuer (generally defined in subsection 1(1) of the *Securities Act* to mean a person or company who takes the initiative in founding, organizing or reorganizing the business of the issuer or who receives, subject to certain specified exceptions, 10 percent or more of a class of securities of such issuer or 10 per cent or more of the proceeds of any offering in consideration for such initiative). See subsections 58(5)-(7) of the *Securities Act*. In addition, the Chief Executive Officer and Chief Financial Officer of the issuer are required to sign the prospectus. See subsection 58(1) of the *Securities Act*.

Under the existing framework, for all practical purposes, every person or company acting as a dealer or adviser in respect of any trade in securities must be registered. The *Securities Act* and the Regulation do provide a number of exemptions from registration requirements which are generally parallel to the prospectus exemptions; however, the availability of most of the registration exemptions was circumscribed in 1987 upon the introduction of the system commonly referred to as universal registration. That system requires "market intermediaries" to register in order to effect trades in securities with respect to which registration was not previously required. A market intermediary is defined broadly under the Regulation as a person or company that engages or holds himself out as engaging, in Ontario, in the business of trading in securities as principal or agent, including those who engage in the business of making a market in securities.[36] With exceptions, a market intermediary is denied various registration exemptions in Ontario, including all of the registration exemptions described below other than the "private company exemption". The effect of universal registration is to prevent unregistered persons from selling securities in the exempt market in Ontario without registration. The rationale for the universal registration system was to cause each person engaged in the business of trading securities to provide certain information to the Commission. Regulations have been adopted categorizing market intermediaries for registration purposes. One of the categories created was that of "limited market dealer", covering those market intermediaries who prior to the advent of universal registration were not required to register as dealers because they were entitled to rely upon the registration exemptions set forth in the *Securities Act* and the Regulation. The registration requirements for limited market dealers are minimal.

Exemptions

The "private placement" exemptions under the *Securities Act* permit distributions of securities to be made without providing purchasers with the protections normally provided under securities legislation through the required delivery of a prospectus.[37] The general policy basis underlying the prospectus exemptions is that, in the circumstances described therein, the mandatory disclosure requirements are unnecessary because of the wealth or sophistication of the purchaser and/or the relationship between the issuer and the investor and the presumed lack of a "need to know" information that would otherwise be contained in a

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[36] See subsection 204(1) of the Regulation.

[37] The description of the prospectus exemptions in this part of the Report is of a summary nature only. For a fuller discussion of these exemptions, reference should be made to David W. Drinkwater, William K. Orr and Rene Sorell, *"Private Placements in Canada"*, The Carswell Company Limited (1985).

prospectus, which suggest that the purchaser can protect himself. The former registration exemptions were premised on the view that, in the circumstances described therein, the involvement of a dealer who meets strict educational proficiency and capital requirements to provide purchasers with professional advice was unnecessary; however, the present system requires "universal registration" on the basis that certain basic information should be provided to the Commission by, and the discipline of the registration requirement should be imposed on, all parties engaging in securities intermediary or advisory activities.

1. *Exemptions Based on the Identity of the Purchaser*

The *Securities Act* contains prospectus exemptions based on the identity and nature of the purchaser, including trades to (a) prescribed institutions; and (b) exempt purchasers.

In Ontario, the prescribed institutions to whom securities may be sold on an exempt basis are banks, loan or trust corporations, insurance companies, governments and certain specified quasi-government agencies.[38]

The *Securities Act* also permits exempt distributions to persons recognized by the OSC as exempt purchasers. Lists of exempt purchasers are made available to the public. To obtain recognition as an exempt purchaser an applicant is required to demonstrate a degree of sophistication sufficient to obviate the need for the investor protective requirements of the legislation. Generally in order to obtain such status an applicant must demonstrate a substantial pool of investment capital (normally $5,000,000 or more) and access to investment expertise (either in-house or through outside advisers).[39]

2. *Minimum Acquisition Cost*

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[38] See clause 72(1)(a) of the *Securities Act*. The corresponding registration exemption, which cannot be relied upon by market intermediaries, is set forth in clause 35(1)3 of the *Securities Act*.

[39] See clause 72(1)(c) of the *Securities Act*. Pursuant to subsection 149(1) of the Regulation, applications for status as an exempt purchaser must be made in accordance with Form 11. The circumstances in which such applications will be granted are briefly described in the Commission ruling dated March 10, 1995, entitled Assignment of Certain Powers and Duties of the Ontario Securities Commission - Determination and Designation (1995), 18 OSCB 1154. A description of the process for applying for status as an exempt purchaser, and a further discussion of the criteria that will be considered in a review of any such application, are set forth in the OSC Staff Practice Note at (1995) 18 OSCB 5781. The corresponding registration exemption, which cannot be relied upon by market intermediaries, is set forth in clause 35(1)4 of the *Securities Act*.

The *Securities Act* also provides an exemption from prospectus requirements where the purchaser purchases as principal if the trade is in a security which has a specified minimum aggregate acquisition cost to such purchaser of $150,000 (prior to 1987, this threshold was $97,000).[40] This exemption was historically based on the presumption that a party prepared to make an investment of that size has a significant incentive to carefully evaluate the investment and would likely also have the degree of sophistication or the means to obtain expert advice to properly evaluate the investment. OSC Policy Statement No. 6.1 ("OSC Policy 6.1") provides that entities such as corporations, syndicates, partnerships and other forms of unincorporated organizations can not be used by parties solely as a means of pooling their acquisition costs for the purpose of meeting the threshold of this exemption.

3. *Limited Offering Exemptions*

The *Securities Act* contains two limited offering exemptions, commonly referred to as the "seed capital" exemption[41] and the "government incentive securities" exemption,[42] which are characterized by limitations on the number of purchasers and on the number of persons solicited and by limiting use of the exemptions to distributions to persons with sufficient sophistication and knowledge so as to not require a prospectus. The necessary knowledge and sophistication on the part of purchasers can be met in a number of ways, including "net worth and investment experience", through consultation with a registrant, or by virtue of their status as or relationship with certain insiders of the issuer. For reasons described below, when such exemptions are relied upon an offering memorandum is typically prepared containing the same level of disclosure as would be the case for a prospectus.[43]

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[40] See clause 72(1)(d) of the *Securities Act* and subsection 27(1) of the Regulation. The corresponding registration exemption, which cannot be relied upon by market intermediaries, is set forth in clause 35(1)5 of the *Securities Act*.

[41] See clause 72(1)(p) of the *Securities Act*. The corresponding registration exemption, which cannot be relied upon by market intermediaries, is set forth in clause 35(1)21 of the *Securities Act*.

[42] See clause 14(f) of the Regulation. The corresponding registration exemption, which cannot be relied upon by market intermediaries, is set forth in clause 151(a) of the Regulation.

[43] There are no prescribed disclosure requirements for an offering memorandum. The sole requirement is that any document constituting an "offering memorandum" for the purposes of section 32 of the Regulation (i.e. a disclosure document other than a simple term sheet or prescribed continuous disclosure document) must contain a contractual right of action which essentially permits a purchaser to whom the offering memorandum is delivered to rescind its purchase of the securities offered thereunder within 90 days of the trade if the offering memorandum contains a misrepresentation. Offering memoranda are not subject to the expanded scope of civil liability applicable to prospectuses pursuant to section 130 of the *Securities Act* and are not reviewed or receipted by OSC staff.

The "seed capital" exemption exempts an issuer selling securities of its own issue from the prospectus requirements where solicitations are made to not more than 50 prospective purchasers and sales are made to not more than 25 purchasers. Each purchaser must have access to substantially the same information concerning the issuer that a prospectus would provide. This requirement has generally been interpreted to mean that a offering memorandum containing prospectus-level disclosure must be provided. This exemption may only be used once by an issuer and once a year by a promoter.

The Regulation contains an exemption for securities designated as "government incentive securities" by the Commission.[44] The exemption is similar to the "seed capital" exemption, except that the numerical limitations are higher in that solicitations may be made to not more than 75 prospective purchasers resulting in sales to not more than 50 purchasers, there are no limitations on the number of times this exemption may be relied upon by either the issuer or the promoter and an offering memorandum is expressly required.

4. *The Private Company Exemption*

The *Securities Act* exempts distributions of securities by private companies from both the prospectus and registration requirements where the securities are not offered to the public.[45] The legislation defines a "private company" to mean a company in whose constating documents the right to transfer shares is restricted, any invitation to the public to subscribe for its securities is prohibited, and the number of shareholders, exclusive of employees and certain former employees,[46] is limited to not more than 50. The phrase "distribution to the public" is not defined. This concept of a "private company" has been interpreted very narrowly by courts and administrators;[47] for example, in *Re Shelter Corporation*,[48] the Commission adopted the restrictive tests developed by the courts[49] in

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44 For a list of the classes of securities designated by the OSC as government incentive securities see Part D of OSC Policy 6.1.

45 See clauses 35(2)10 and 73(1)(a) of the *Securities Act*.

46 Only former employees who became shareholders while they were employees and continued to be shareholders after the termination of their employment.

47 See Peter Dey, "Exemptions under the Securities Act of Ontario", (1972) Law Society of Upper Canada Lectures 127, and the MacIntosh Paper at pp. 100-101.

48 *Re Shelter Corporation of Canada Ltd.* (1977), O.S.C.B. 6 (O.S.C.).

49 See *SEC v. Ralston Purina Co.* (1953), 316 U.S. 159 (U.S.S.C.) and *R. v. Piepgrass* (1959), 23 D.L.R. (2d) 220 (Alta.C.A.).

holding an investor will not be considered to be part of the public only if such investor is not a person who is in need of prospectus disclosure *and* is a person who has common bonds of interest or association with the seller.

5. *The "Closed System"*

Once securities have been traded in reliance upon a prospectus exemption they become subject to a set of resale restrictions which are commonly referred to as the "closed system". The rationale for the regulation of resales (or "secondary trades") is that purchasers of securities issued by an issuer pursuant to a prospectus exemption could otherwise potentially serve as a conduit to purchasers not entitled to rely on a prospectus exemption (commonly referred to as "backdoor underwritings"), thereby effectively circumventing the prospectus requirement. The resale rules restrict resales by deeming such sales to be distributions, thereby requiring that a prospectus be provided, an exemption be relied upon or regulatory relief be obtained, unless certain specified conditions are met. The closed system and the rules governing secondary trades are described in further detail in Part IX of this Report.

B. Problems with Existing Framework

In our view, the existing framework of prospectus and registration exemptions is inadequate for the following reasons:

1. There is considerable uncertainty as to the scope of exemptions because of the use of vaguely defined or undefined concepts such as "offered for sale to the public" and "net worth and investment experience".

2. The restrictions inherent in some of the exemptions, and the restrictive manner in which the scope of certain of the exemptions have been interpreted, have in our view unduly restricted SME capital formation in circumstances where the protections of the prospectus requirements are not required.

These problems have resulted in a substantial amount of non-compliance.[50] Although not all of such non-compliance is necessarily harmful to the investing public, some situations involving non-compliance and the very existence, amount and widespread and

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[50] See the MacIntosh Paper at pp. 99-104.

accepted nature of the non-compliance tends to undermine the integrity of, and investor confidence in, the regulatory regime.

A discussion of issues relating specifically to relevant elements of the universal registration system is set forth in Part VIII below.

As noted by Professor MacIntosh,[51] the mismatch between these requirements and the needs of small business is at its greatest in relation to investments of "love money" and investments by "angel" investors (for descriptions of these types of investments see Part III.A above). In "love money" transactions, only the private company exemption will generally be of any use in facilitating the issuance of securities without a prospectus. This is so because few suppliers of "love money" make investments of $150,000 or more so as to qualify for the $150,000 exemption. Moreover, the limited offering exemptions, which effectively limit the amount of money which can be raised, which require that the investor be able to evaluate the investment either on the basis of net worth and investment experience or by virtue of consultation with or advice from a registrant, and which have often been interpreted as requiring that the issuer assemble an offering memorandum that essentially replicates a prospectus, will typically not be available or practicable. However, as noted above, the private company exemption is not available in respect of distributions of securities to the "public". Given the extremely broad interpretation that has been given to the term "public" in this context, very few purchasers can comfortably rely on the private company exemption. We believe that the decisions of suppliers of "love money" to invest in an enterprise are unlikely to be substantially affected by the provision of a prospectus and that the costs of preparing a prospectus do not justify its benefits to these investors. Anecdotal evidence suggests that most investments of "love money" continue to be made in violation of current regulatory requirements regardless of the associated risks.

Similarly, an "angel" investor would typically be unable to find an applicable prospectus exemption, notwithstanding that such investors tend to be very sophisticated, experienced and prudent investors who typically conduct extensive due diligence and who demand extensive disclosure from entrepreneurs. For reasons noted above, the private company exemption will be unavailable if the "angel" investor does not initially share common bonds of association with the entrepreneur, which is typically the case. Moreover, as noted above, "angel" investors typically prefer to invest substantially less than $150,000, and because the seed capital exemption has been conservatively interpreted by the legal

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[51] See the MacIntosh Paper at pp. 99-101. See also Professor Jeffrey G. MacIntosh, *"Regulatory Barriers to Raising Capital for Small Firms"*, Canadian Financial Services Alert, vol. 6, issue 8, July, 1994, at p. 57.

community as requiring that the issuer assemble an offering memorandum which contains prospectus-like disclosure, the benefits of that prospectus exemption have been dramatically undermined. It is our view that the full protection of the prospectus requirements of the *Securities Act* are unnecessary and unjustified on a cost-benefit analysis for sophisticated investors such as "angel" investors.

When the prospectus exemption based upon the minimum aggregate acquisition cost to the purchaser was implemented on July 8, 1966, the specified minimum acquisition cost ($97,000) was thought to be a proxy for the sophistication of the purchaser. This exemption was based on the presumption that a party prepared to make an investment of that size has both a significant incentive to carefully evaluate the investment and the degree of sophistication or the means to obtain expert advice to properly evaluate the investment. We believe that the existing exemption ($150,000 minimum acquisition cost) is not a satisfactory proxy for sophistication. If the exemption were to be adjusted to August, 1996 for inflation from June 17, 1987, the date on which the $150,000 threshold was set, the threshold would be approximately $195,000; if the $97,000 threshold were adjusted for inflation (from July 8, 1966) it would be approximately $493,000.[52] However, the Task Force does not believe that raising the exemption to approximately $500,000 (and indexing it to inflation) is the appropriate response. Essentially, we believe that a minimum acquisition cost is a poor proxy for sophistication. In order to serve as an adequate screen it must be so high as to filter out many who are not in need of the legislative protections created. At a minimum, the use of a monetary threshold tends to distort economics by causing an investor to invest more than business considerations dictate solely in order to meet the threshold.[53] Furthermore, it is illogical from a securities regulatory perspective that an investor has an exemption available to make, for example, a $250,000 investment, but may not make that investment on an exempt basis in two steps, even where the staged investment better protects the investor's interests. We acknowledge that an exemption based on an aggregate acquisition cost is convenient because only a cheque or other banking record is necessary to establish reliance on the exemption. For this reason alone we considered the idea of raising the $150,000

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52 The inflation adjustments are based upon Statistics Canada's 1986-Based Canada All-Items Consumer Price Index ("CPI"). The three key monthly measures of the CPI for the purposes of calculating these inflation adjustments are:

Month	Index Value
July, 1966	26.7
June, 1987	104.4
August, 1996	135.7

53 See the MacIntosh Paper at p. 103.

threshold to $1,000,000, although that concept was ultimately rejected because we believe that the relative sophistication of a purchaser should be evaluated with reference to measures of sophistication (such as knowledge, experience and wealth) outside of the context of the specific investment.

Practical problems have also been identified with the limited offering exemptions. In addition to the consequences of the requirement to provide access to the same information that a prospectus would provide, as described above, evidence and experience suggest that the solicitation limitations are unenforceable and the fact that selling or promotional expenses can be paid or incurred for services performed by a registrant has been abused by a number of limited market dealers.

The Task Force believes that the problems described above are imposing costs on, and/or placing impediments before, SME financing activity which are unnecessary or disproportionate to the significance of the underlying regulatory objectives in the circumstances. Anecdotal evidence suggests that much SME financing activity is being conducted which does not fit within the existing regulatory framework but which should, in our view, be permitted or even encouraged if an appropriate balance is to be effected between SME capital formation needs and regulatory objectives such as investor protection.

C. Recommendations for Reform

Our recommendations for reform of the prospectus and registration exemptions are as follows:

1. **We recommend the creation of a new prospectus exemption for trades in securities of "closely-held business issuers", with a parallel registration exemption (subject to universal registration). "Closely-held business issuers" would be defined as issuers with twenty-five or fewer securityholders (after giving effect to the proposed financing) but exclusive of both accredited investors and employees and certain former employees of the issuer and its affiliates. The lifetime aggregate amount of securities sold under this exemption by an issuer (and related issuers) would be limited to $3 million. Promoters would be entitled to rely upon the exemption only once in any twelve month period.**[54]

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[54] For comparison, it should be noted that Professor MacIntosh recommends, at p. 104 of the MacIntosh Paper, that issuers with less than 25 or 50 shareholders be exempt from the prospectus requirements.

Unlike the existing "private company" exemption, the recommended new exemption could be relied upon in respect of trades of securities of issuers which are not organized as corporations, such as limited partnerships and unincorporated associations. This innovation is consistent with the spirit of the Commission's proposals for legislative reform published August 10, 1984, which recommended, among other things, replacement of the "private company" exemption with a "private issuer" exemption, and is also consistent with the analogous exemption under the securities laws of British Columbia, Nova Scotia and Saskatchewan.[55] The use of the broader concept of an "issuer" reflects our view that there is no rational basis to limit the availability of the exemption to corporate entities, given that SMEs may be organized as non-corporate entities for valid business and tax-related reasons.

The recommended new exemption also differs from the existing "private company" exemption in that the requirements that the issuer be "private" and that distributions made in reliance upon the exemption not be made "to the public" have been omitted from the proposed new exemption. The decision not to incorporate these concepts was based in part on our view that the ambiguity of the phrase "to the public" has created a great deal of uncertainty and that because of the very broad interpretation of that phrase the ambit and utility of the "private company" exemption have been severely and unnecessarily limited. Moreover, the nature of the pre-existing relationship between the issuer and its investors should not in our view be the critical determinant for reliance on the exemption. The purpose of the proposed exemption is to facilitate investments of "love money" and/or investments by "angel" investors at relatively early stages of an enterprise's development. The Task Force's conclusion that the investor protection requirements of the legislation are unnecessary or inappropriate in respect of those investments is not dependant on whether they or prior investors (including, for example, accredited investors who would typically be at arm's length from the issuer) are members of the "public" with respect to the issuer. In our view, the exemption should properly be available to developing enterprises which do not have broad classes of equity holders (i.e. "closely-held") and which are actively engaged in business development and expansion and require capital for those purposes (i.e. business issuers).

Because issuers would be permitted to distribute securities to the public (whatever the meaning of that term) in reliance upon the recommended new exemption, consideration was given as to whether it would be practicable and appropriate to restrict the types or nature of advertising which could be used by issuers relying on the exemption. The Task Force

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[55] See clauses 89(h) and 128(i) of the British Columbia Securities Rules, clause 78(1)(a) of the *Securities Act* (Nova Scotia) and clause 82(1)(a) of the *Securities Act* (Saskatchewan). Section 54 of the *Securities Act* (Quebec) provides that no prospectus is required for the distribution of voting securities (without limiting the provision to securities of incorporated entities) where the number of holders of those securities after the distribution does not exceed five, provided that the distribution is made without advertising.

determined that such restrictions were neither necessary, because the $3 million lifetime cap on the exemption (discussed below) would effectively limit the utility of advertising, nor practicable, because limitations on each of the advertising medium, the audience and the information advertised are inflexible, arbitrary and very difficult to enforce. Restrictions on advertising applicable specifically to the closely-held business issuer exemption would also be practically inconsistent with part of the conceived purpose of the exemption as a limited residual category for investors who are not accredited investors (as discussed below), as such restrictions would require the issuer to categorize its advertising audience at the outset and to customize the advertised information to each segment of investors. Moreover, as discussed in Part IV.D below, the Task Force recommends that the principles concerning marketing of securities described in Draft National Policy Statement No. 43 ("Draft National Policy 43"),[56] which incorporates the concept of civil liability for misrepresentations in advertisements, be adopted in respect of private placements under the closely-held business issuer exemption, and that there be deemed reliance on misrepresentations, which should have a corresponding deterrent effect on abusive marketing practices.

The recommended closely held business issuer exemption is similar to Rule 506 of Regulation D ("Regulation D") under the United States Securities Act of 1933, which permits issuances of securities on a prospectus-exempt basis to a class of 35 persons over and above issuances to accredited investors. This reform reflects our view that issuers should be permitted access to a group of "love money" or "angel" investors distinct from the class of investors which qualifies as accredited investors. We believe that this reform will facilitate investments of "love money" and certain investments by "angels" throughout the various stages of an SME's development.

Like the existing private company exemption, employees and certain former employees of the issuer and its affiliates are excluded from the numerical threshold of the closely-held business issuer exemption. The exclusion for employees would include all full-time employees, while the exclusion for former employees would be limited to those who had purchased securities during, and had continued to hold such securities since, the termination of their employment. The Proposal for Comment had proposed that employees not be excluded from the numerical threshold, based in part on anecdotal evidence of distributions of securities to employees in reliance upon the private company exemption in circumstances where the investor protection elements of the regulatory regime were clearly appropriate. The Task Force maintains the view that the intention and spirit of the private company exemption was to permit closely-held enterprises to include employees who are relatively involved in or

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[56] Draft National Policy Statement No. 43 - Advertisements of Securities and Related Sales Practices (1994), 17 OSCB 5133, October 28, 1994.

knowledgeable of the affairs of the company in the ownership and growth of the business, and that the exemption was not intended to be used as an accommodation for the raising of funds from large groups of peripheral employees. Nevertheless, the Task Force has determined to exclude employees from the 25 person limit of the exemption (i.e. not to count employees in that calculation) because the objective of employee ownership is of such importance and is clearly recognized in the existing regulatory framework.[57] The Task Force believes that the potential for inappropriate reliance on the exemption will be limited by both the $3 million lifetime cap on the exemption and by requiring that issuances to employees under the exemption be subject to the condition that such employees are not induced to purchase by expectation of employment or continued employment.[58] This Recommendation would <u>not</u> affect the existing prospectus exemption for issuances of securities to employees; its only effect would be to not include employees in determinations as to the availability of the closely-held business issuer exemption.

Because of the exclusion of employees from the numerical threshold of the exemption, the Task Force lowered the exemption's threshold to twenty-five investors, to restore balance to the Task Force's assessment of the maximum number of non-accredited investor securityholders which should be necessary and appropriate to facilitate capital formation. The twenty-five securityholder limit would apply to all classes of securities, including debt securities (as does the threshold in the existing private company exemption); the nature of the securities held does not affect the rationale for the limit, and it is not the Task Force's intention to create a bias in favour of debt or debt-like securities to encourage circumvention of the threshold.

The definition of a "closely-held business issuer" would incorporate a requirement that all transfers of securities of the issuer, other than transfers to accredited investors, would be subject to the approval of the issuer's board of directors; in that way the issuer's board could control the number of securityholders and prevent the filling (and the crossing) of the twenty-five securityholder limit through investor resales. In addition, to countenance situations where a number of investors might otherwise combine their investments through a single vehicle to circumvent the securityholder limit, the Task Force recommends that rules such as those set forth in OSC Policy 6.1 dealing with vehicles formed to facilitate access to the exemption apply to investments pursuant to the closely-held business issuer exemption.

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57 See clause 72(1)(n) of the *Securities Act*, which exempts trades by issuers in securities of their own issue to employees or employees of affiliates from the prospectus requirements of the statute where such employees are not induced to purchase by expectation of employment or continued employment. The parallel registration exemption is in clause 35(1)19 of the *Securities Act*.

58 This latter condition is consistent with clause 72(1)(n) of the *Securities Act*. See footnote 57.

For example, if two investors purchased securities of an SME pursuant to the closely-held business issuer exemption through a jointly-owned holding company established to make that investment each of those two investors should be counted separately in determining whether the 25 person limit has been reached. Investors to whom securities have been issued pursuant to the closely-held business issuer exemption would be entitled to resell such securities pursuant to the closely-held business issuer exemption itself (which would not be limited to issuances by the issuer itself), subject to the approval of the issuer's board of directors, or pursuant to the accredited investor exemption discussed below.

The $3 million limit per related group of issuers has been added to prevent abuse of the exemption in circumstances where the prospectus requirements of the *Securities Act* (as well as the registration requirements thereof, even where no market intermediary is involved) should apply. The limit is to be calculated with reference solely to proceeds of issuances of securities to an issuer, and does not include any amounts paid to the issuer's securityholders on resales of securities. The Task Force considered amounts ranging from $1 million to $5 million. The threshold selected is an arbitrary figure reflecting the Task Force's sense of an appropriate balance between SMEs' needs for start-up capital and the stage at which access to supplies of equity capital by alternative means would be more appropriate. It should be borne in mind that under the closely-held business issuer exemption there are no restrictions of any nature on the type of investor to whom an SME can issue securities; investors need not be sophisticated or familiar with the issuer or its business, and consequently the potential for unscrupulous promoters to rely upon the exemption is apparent. Nevertheless, the threshold must not be set at a level too low to permit adequate start-up financing. For the purposes of defining what constitutes a related group of issuers, the Task Force recommends that where issuers are directly or beneficially owned or *de facto* controlled as to twenty per cent by a common person (including affiliates) such issuers should be considered to be related.

In addition, we recognize that both the number of shareholders and the amount of money that can be raised pursuant to this exemption must be subject to anti-avoidance provisions so that unscrupulous promoters cannot circumvent those limitations by establishing separate issuers all of whose assets are directed to the same business enterprise. The current clause 72(1)(p) of the *Securities Act* provides that a promoter may only use that exemption once a year. We recommend that a similar restriction be adopted with respect to the closely-held business issuer exemption, such that a promoter may only use the exemption once (with respect to a single issuer) within any given twelve-month period. Unlike the restriction applicable to clause 72(1)(p) of the *Securities Act*, the recommended restriction would apply to all promoters, including registered dealers. The Task Force recognizes that entrepreneurs may fail at several businesses before they are successful in capitalizing a particular idea, and

that if an issuer undertakes a project which fails and management is unable to finance a different project with a prospect for success, that issuer's shareholders may effectively be deprived of an opportunity to recoup their losses. However, we still believe that a limitation should be imposed on use of the exemption to prevent abuse; where the enterprise to be financed is truly and demonstrably different and not an artifice to circumvent the limitations of the exemption, the entrepreneur can seek and should be able to obtain discretionary relief.

In our view, the rationales for an exemption from the prospectus requirements of the *Securities Act* for securities of closely-held business issuers warrant a parallel registration exemption; to conclude otherwise would partially undermine the benefits of the exemption, and be impractical in the circumstances in which the exemption would typically be used. Nevertheless, the Task Force recommends that the parallel registration exemption should be subject to universal registration; accordingly, if a market intermediary is involved in a trade, that market intermediary should be registered.

2. **We recommend that SME issuers with more than five securityholders (including employees) be required to provide a generic information statement about the nature of SME investments to each investor (other than accredited investors) to whom securities are sold by such issuer or selling securityholder in reliance upon the closely-held business issuer prospectus exemption not less than four business days prior to the investment.**

The Task Force believes, particularly in view of the fact that the evidence reviewed to date suggests that exempt investors such as "angel" investors demand and receive an appropriate level of disclosure, that the benefits of mandated disclosure are outweighed by the significant costs in the case of investors acquiring securities under the closely-held business issuer exemption. While such investors may generally appreciate the inherent risks in SME equity investments, the Task Force is of the view that it would be of net benefit for issuers to provide such investors with a generic information statement concerning investing in SMEs.[59] Such a statement would inform potential investors in general terms as to what information he or she should ask for and assess before making the investment decision, such as information regarding:

(a) the business and technical background of senior management;

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[59] The North American Securities Administration Association ("NASAA") has adopted such a generic information statement. A copy is attached as Appendix D.

(b) the composition of the board of directors;

(c) an audited balance sheet for the issuer;

(d) historic financial statements and auditors' reports, if any;

(e) the assumptions underlying the forecasts or projections, including auditors' reports, if any;

(f) length of operating history;

(g) the possibility of litigation regarding claims to intellectual property or other assets;

(h) plans for utilization of funds raised through the investment and whether such funds are sufficient to finance the project; and

(i) the liquidity of the security.

There would be no requirement for issuers or selling securityholders to provide the above information, simply a requirement to give potential investors a statement that this is the type of information investors should obtain and assess. The statement would also include advice that potential investors who do not feel capable of assessing this information should seek professional advice. The Task Force suggests that the Commission regularly publish a suggested form of generic information statement, which published form would serve as an optional, but not mandatory, standard form. The statement could be tailored by the issuer to its specific industry or enterprise, provided that the customization does not derogate from the spirit of the statement.

The Task Force considered permitting delivery of the generic information statement close to the time of or even after the investment provided that a reasonable withdrawal period would be provided to investors. However, it was determined that delivery not less than four business days prior to the investment would be more appropriate, given that the nature of typical relationships between closely-held issuers and their investors (particulary investors of "love money") may make pre-investment requests for and provision of relevant information more likely and may also make an exercise of withdrawal rights difficult. The generic information statement would be delivered by the issuer, even where the sale is to be effected by a selling securityholder, because the issuer is more likely to have a current version of the required form of generic information statement and because the issuer will in any event be

involved in such resales, which will (as discussed above) be subject to the approval of the issuer's board of directors; however, the selling securityholder will bear responsibility for ensuring timely delivery of the form. The selling securityholder will have the right to compel the issuer to deliver the form, failing which the selling securityholder itself would have the right to effect such delivery.

Although consideration was given to providing that investors making claims against issuers or selling securityholders would be deemed to have relied on the information statement, it was determined that such a standard of deemed reliance would operate against investors' interests, given the cautionary language certain to form part of delivered information statements. Failure to comply with the information statement delivery requirement would render the issuance voidable by a court of competent jurisdiction unless the issuer or selling securityholder is able to demonstrate that no prejudice resulted from the issuer's or selling securityholder's non-compliance. We recognize that this requirement will create some uncertainty as to whether private placements have been properly effected; nevertheless, we believe that this uncertainty will be limited if proper records of exempt distributions and the related delivery of information statements are maintained.

The Task Force also considered what liability should attach to misrepresentation in any information provided by closely-held business issuers over and above (or as a consequence of) the generic information statement. The Task Force has recommended the deletion of section 32 of the Regulation which would require all information (with certain specified exceptions) provided to investors to include a contractual right of action,[60] based on its belief that the contractual right of action in offering memoranda has not provided a practical and meaningful remedy to investors. Investors to whom misrepresentations are made in information provided by closely-held business issuers, whether such information was specifically requested or not, will have remedies at common law; the only modification to this common law liability recommended by the Task Force is a standard of deemed reliance, which should in this context operate in investors' interests by eliminating a significant hurdle to successful prosecution of a misrepresentation action. The failure to provide information requested by an investor would not give rise to a specified remedy; the investor's remedy in that circumstance should be not to invest.

The Task Force gave serious consideration to the desirability of maintaining the offering memorandum requirement. Offering memorandum requirements are heavily relied upon in many Canadian jurisdictions, and efforts have been made in certain of these jurisdictions to refine the requirement somewhat in order to provide issuers with some

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[60] See footnotes 43 and 69.

guidance as to the content requirements. The offering memorandum requirements were designed to serve three related functions: (i) to cause disclosure to be provided to investors; (ii) to provide some protection to investors in the event of losses resulting from misrepresentations; and (iii) to deter vendor misrepresentations. The mandated contractual right of action (described in Part IV.A above), in particular, is related to the latter two objectives. However, as discussed above, the offering memorandum requirement has been interpreted as effectively requiring that prospectus-like disclosure be provided to investors, which dramatically undermines the utility of the relevant exemptions. The Task Force believes that the obstacle to SME capital formation presented by the offering memorandum requirement is unjustifiable even if the offering memorandum disclosure requirements were to be more specified and streamlined, and that a more efficient means of accomplishing the disclosure objective is through the delivery of the generic information statement containing warnings about SME investments and advising investors to request information relevant to their investment decisions. As to the investor protection or "insurance" objective, which was of limited utility in any event because of the ninety day limitation in clause 32(1)(b) of the Regulation, and the deterrence objective, these incentives will continue as liability will attach to misrepresentations in that information which is delivered upon request by investors.

There will be circumstances, such as the sale of an incorporated sole proprietorship with one or two shareholders where generic information statements would not be appropriate; purchasers in those limited circumstances should not be entitled to rescind their investment for failure to deliver a generic information statement. For that reason the Task Force has recommended that the information statement delivery requirements not apply to trades in securities of closely-held business issuers with five or fewer securityholders.

3. **We recommend the establishment of a new exemption from the prospectus and registration (subject to universal registration) requirements of the *Securities Act* for a class of "accredited investors", which class shall include (i) a list of prescribed institutions, (ii) corporations having $5 million or more in assets, (iii) persons with a net worth of not less than $1 million or net income over a specified threshold and (iv) the issuer's management.[61] There would be no limitation on the number of solicitations, number of purchasers, or on the number of times the exemption could be relied upon. Generally, no disclosure materials would be required to be provided to accredited investors.**

61 This list is a summary only. The complete definition is set forth below.

The classes of accredited investors who would be permitted to rely on the new exemption (in each case purchasing solely as principal) would be the following:

(a) a bank to which the *Bank Act* (Canada) applies;

(b) a loan corporation or trust company registered under the *Loan and Trust Corporations Act* (Ontario);

(c) an insurance company licensed under the *Insurance Act* (Ontario);

(d) Credit Union Central of Canada, Credit Union Central of Ontario or La Fédération des Caisses Populaires de l'Ontario Inc.;

(e) the government of Canada or any province or territory or municipality of Canada or any agency thereof;

(f) a national, federal, state, provincial, territorial or municipal government of or in any nation or any agency thereof;

(g) a regulated pension fund or pension society sponsored by an employer for the benefit of its employees or employees of an affiliate and having assets of at least \$5 million as of the date of its most recently audited balance sheet;

(h) a registered charity under the *Income Tax Act* (Canada) that has investment assets of not less than \$5 million as of the date of its most recent audited balance sheet;

(i) an individual who, together with such individual's spouse,[62] has a net worth (including registered retirement savings plans but excluding one-half of the net equity of such individuals' personal residence(s)) at the time of purchase exceeding \$1 million;

(j) an individual whose income is in excess of \$200,000 in each of the two most recent years or whose joint income with that person's spouse[63] is in excess of

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[62] Including a person with whom that person is living in a conjugal relationship outside marriage.

[63] Including a person with whom that person is living in a conjugal relationship outside marriage.

$300,000 in each of those years and who, in either case, has a reasonable expectation of reaching the same income level in the current year;

(k) an officer, director or promoter of the issuer;

(l) a parent, brother, sister or child of a person mentioned in (k);

(m) a person to whom a person mentioned in (k) is married or with whom such a person is living in a conjugal relationship outside marriage;

(n) a person or company who is, as regards the issuer, a person or company referred to in clause (c) of the definition of "distribution" in subsection 1(1) of the *Securities Act*;

(o) an active or retired registrant under the *Securities Act*, and an unregistered research analyst employed by such a registrant;

(p) a corporation, limited partnership, trust or estate that has net assets of at least $5 million as of the date of its most recent audited financial statements;

(q) persons or entities recognized by the Commission as accredited investors;

(r) a mutual fund or non-redeemable investment fund that distributes its securities in Ontario only to persons or companies referred to in clauses (a) through (q);

(s) a mutual fund or non-redeemable investment fund that distributes its securities in Ontario under a current prospectus for which a receipt has been granted by the Director of the OSC which discloses that it is relying on this exemption and, if it has any restrictions with respect to its ability to rely on this exemption, discloses such restrictions;[64]

(t) a mutual fund or non-redeemable investment fund which was established prior to the date on which the accredited investor exemption becomes effective and which distributed its securities in reliance on an available exemption provided

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[64] Mutual funds or non-redeemable funds need not (but may) choose to restrict the use of this exemption until they are of a certain size or with respect to certain percentage of their net asset value. If the securities acquired under this exemption are illiquid National Policy Statement No. 39 restricts the mutual fund to investing not more than 10% of its net asset value in such securities.

that it distributes its securities thereafter only to persons or companies referred in clauses (a) through (q);

(u) an entity organized outside Canada which is analogous to the entities referred to in clauses (a) through (d), (p) or (r) through (t) in form, function and, in the case of entities analogous to those referred to in clauses (r) through (t), in the nature of its securityholders; and

(v) a person or company in respect of which all of the owners of interests, direct or indirect, legal or beneficial, are persons or companies referred to in clauses (a) to (u).

Any person or corporation who falls within one or more of the classes described in clauses (a) through (v) or who the issuer has no reasonable basis on which to believe that the investor does not fall within the claimed exemption will be an accredited investor. Generally, a representation by an investor as to his or her qualifications as an accredited investor will be adequate, provided that if a dealer is involved it has an appropriately completed new client application form which has been revised within the past year and it has no reason to believe on the basis of the information contained therein or other account information that the representation is incorrect.

The Task Force believes that this standard of actual knowledge without inquiry on the part of the vendor is the appropriate standard. The vendor would be required to obtain a certificate from the investor, which certificate would have a list of the various bases for qualification as an accredited investor and a space for the investor to indicate the basis (or bases) for his, her or its qualification. In the view of the Task Force that is the extent to which it is appropriate, in the SME financing context, to protect investors from themselves.

For the purposes of the income test, income will be net income before the provision for income tax; it need not be specifically defined, but should include employment income, investment income, the net income of a sole proprietorship and contributions to a profit-sharing plan or pension plan to the extent that the participants' rights are vested. Use of an objective standard such as income reported for tax purposes could be used. In addition, accredited investors other than those referred to in clauses (a) through (f) above (and investors analogous to those entities which qualify as accredited investors pursuant to clause (u) above) would be required to give a representation to the vendor that the investment is suitable. The

vendor would be entitled to rely on such representation, and (unlike any registrants involved in a trade) the vendor would not have a "know your client" obligation.[65]

Because not every circumstance which justifies accredited investor status can be foreseen, clause (q) permits investors to apply to the OSC for such status. This recognition would be given on a general basis, like the existing exempt purchaser exemption, rather than on an offering-specific basis. Because of concerns about possible abuse of this provision, the Task Force recommends that there be a sixty day delay between an application and the granting of status; this time period reflects our sense of the appropriate balance between discouraging high pressure applications submitted under pressure from unscrupulous issuers or promoters and reasonably accommodating legitimate applicants who cannot fit within one of the listed categories but who do not need the protection of the prospectus requirement.

Clause (v) allows accredited investors to form partnerships and establish joint venture corporations and/or investment funds whose status will be that of an accredited investor.

Many commentators have suggested that accredited investors be defined by or at least include persons whose educational qualifications or prior business experience suggests that they do not require the protections of the *Securities Act*. The Task Force considered whether persons meeting certain educational or professional standards (e.g. a masters in business administration, a degree in accounting or a law degree or having completed the Canadian Securities Course or members of certain professional bodies such as The Law Society of Upper Canada, the Ontario Institute of Chartered Accountants and other professional accounting organizations, persons registered by the Commission as advisers or salespersons or officers or directors or partners of brokers or persons exempt from registration as advisers due to their qualification as portfolio managers under applicable stock exchange rules) should be accredited investors for all purposes. A majority of the Task Force concluded that such an approach is generally inappropriate, because sophistication in this context is and should be measured principally by the financial ability of the investor to withstand the loss of the investment, and standards based on education or experience do not necessarily incorporate this factor. The Task Force was also not persuaded, except as discussed below, that members of such groups uniformly had the investment-related sophistication necessary to qualify as an accredited investor. The sole exception is registrants (both active and retired), including salespeople and unregistered research analysts employed by registrants; the basis for this

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65 The "know your client" obligation, described in Part IV.A above, generally requires registrants to make inquiries as to clients' creditworthiness, investment needs and objectives and to consider the suitability of investments to an individual client. See subsection 114(4) of the Regulation.

exception is that persons who by virtue of their professional qualifications ordinarily give, directly or indirectly, and are paid for investment advice to others and are permitted by the *Securities Act* to do this should be regarded as accredited investors. The Task Force also examined the concept of relating a person's education or previous business experience to the type of business conducted by the issuer and determined that defining an accredited investor on the basis of such a connection was unworkable. We recognize that with respect to the sale of securities of any particular issuer there may be persons or companies who would be properly classified as sophisticated, but who do not meet the foregoing definition. Hopefully, the closely-held business issuer exemption described above will afford those individuals the ability to purchase securities of the issuer should they choose to do so.

The Task Force considered whether venture capital funds should be included as a discrete class of accredited investors. However, the Task Force believes that most if not all of such funds are organized as corporations or trusts, and should therefore qualify as accredited investors only if they meet the test for such entities as set forth in clause (p) above.

There was support on the Task Force for the net worth threshold in clause (i) to be lower than $1 million; however, the majority of the Task Force members continue to believe that $1 million is the appropriate amount. The net worth threshold has been revised to clarify that net worth should be calculated with reference to both the investor and the investor's spouse and should include registered retirement savings plans.

Other revisions made to the classes of accredited investors proposed in the Proposal for Comment include: (i) the inclusion of non-Canadians governments and business entities, which are presumed to have a degree of investment sophistication similar to their Canadian counterparts; (ii) the inclusion of limited partnerships, trust and estates with assets of $5 million, because in the Task Force's view the differing legal characteristics between those entities and corporations are not sufficient to warrant differential treatment; and (iii) the lowering of the asset threshold for pensions to $5 million, based in part on the Task Force's assumption that pensions with assets at or above that amount commonly retain qualified arm's length investment advisers.

The proposed concept of "accredited investors" is analogous to the class of accredited investors prescribed by Regulation D.[66] The adoption of a "bright-line" test for determinations as to whether persons have a sufficient degree of sophistication to make

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[66] An alternative proposal for reform based upon elements of Regulation D is made at page 105 of the MacIntosh Paper.

investments in securities on a prospectus-exempt basis is consistent with the approach adopted by the BCSC as part of its recently enacted comprehensive reform to securities regulation in that province, although the British Columbia definition relies only partly on a "bright-line" test.[67]

Adoption of a new "accredited investor" exemption along the lines proposed by the Task Force would permit a broader class of investors (whose degree of sophistication and ability to evaluate the potential investment have been determined by clear and easily understood "bright-line" tests) to make investments in SMEs in amounts less than $150,000 without requiring the issuer to prepare an offering memorandum with prospectus-like disclosure in circumstances where the protections of the prospectus requirements of the legislation are unnecessary.

Because the very basis of our proposed accredited investor exemption is the presumed sophistication of the investor, and given what we perceive to be as the limited benefits of mandated disclosure requirements in these circumstances, it is our view that mandated disclosure requirements are inappropriate for distributions to accredited investors and would add an unnecessary impediment to use of the exemption. The evidence concerning investor characteristics (described in Part III.B above) suggests that accredited investors are typically prudent and experienced investors who would generally require (and, given the balance of bargaining power in investor/SME relationships, would likely receive) that degree of disclosure as necessary in the circumstances.

The Task Force also considered whether a standard of deemed reliance should apply to disclosure materials provided to accredited investors by issuers relying on the accredited investor exemption. In its interim report[68] the TSE Committee on Corporate Disclosure recommended that a statutory cause of action for damages arising as a consequence of misrepresentations be available to persons trading in the secondary market between the date

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67 "Sophisticated purchaser" is defined in section 1 of the British Columbia Securities Rules to mean an investor who is able to evaluate the risks of an investment by virtue of relevant experience or access to professional advice, who meets certain qualifications or numeric wealth and income-oriented thresholds, and who delivers an acknowledgement to the vendor in prescribed form acknowledging the risks of the investment and setting forth that specific qualifications of the investor to purchase under the various available prospectus exemptions. The said numeric thresholds are, in the case of an individual, either net worth (jointly with the individual's spouse) of not less than $400,000 or annual net income for the two past years and for the then current year (based on reasonable expectations) of not less than $75,000 (or $125,000 on a joint basis with the individual's spouse). The thresholds for a corporation, partnership or trust are equivalent to those applicable to an individual jointly with his or her spouse.

68 See The Toronto Stock Exchange Committee or Corporate Disclosure, "Toward Improved Disclosure", December 1995, particularly Chapter 6.

when misleading disclosure was made and the date on which it was corrected (or, in the case of non-disclosure, between the date when disclosure ought to have been made and the date when it was in fact made), with a standard of deemed reliance, but proposed that private placees of securities not benefit from the proposed remedy on the basis that private placees have the ability to and do bargain with the issuer for a negotiated level of liability and the law should not intervene in such private arrangements. While we agree that the law should not displace agreements between parties with equal sophistication and bargaining power, in our view a standard of deemed reliance should be presumed to apply unless waived by the investor, primarily because of the significance of the hurdle that proof of reliance is in misrepresentation actions. For the same reason, a presumptive standard of deemed reliance would apply where accredited investors prosecute actions for alleged misrepresentations in advertisements.

The present distinction in the *Securities Act* between accounts fully managed by banks, trust companies, insurance companies and registered advisers has not been maintained; each such institution could only rely upon the accredited investor exemption for purchases as principal and not for managed accounts. Significant consideration was given to including as accredited investors all accounts managed by accredited investors, regardless of the characteristics of the accountholders; however, because a critical element in defining accredited investors should, in our view, be the ability to withstand the loss of an investment, and because management of an account does not (and is not intended to) guarantee the success of an investment, the Task Force determined that financial institutions managing investors' accounts can purchase under the accredited investor exemption only as principal. For greater certainty, a managed account will qualify as an accredited investor only if the managed account itself so qualifies and not because of the type or qualification of the institution managing the account.

As in the case with respect to the proposed closely-held business issuer exemption, the Task Force is of the view that the rationale for an exemption from the prospectus requirement of the *Securities Act* for distributions to accredited investors also justifies an exemption from the registration requirement, provided that any market intermediary participating in a trade involving accredited investors would still have to be registered.

The Task Force is not proposing that the "closed system" (discussed in Part IX below) be eliminated. Unless an investor to whom securities were issued under the accredited investor exemption sells by way of a prospectus, obtains discretionary relief from relevant securities regulatory authorities or awaits the expiration of the applicable hold period (which would be subsection 72(4) of the *Securities Act*), such investor would be permitted to sell his, her or its securities only in reliance upon a further exemption (including the accredited

investor exemption and, subject to the approval of the issuer's board of directors, the closely-held business issuer exemption).

4. **We propose that the existing private company, prescribed institutions, exempt purchaser, $150,000, seed capital and government incentive securities exemptions and related provisions be eliminated.**[69]

For the reasons noted in Part IV.B above, it is our view that the existing framework of exemptions does not effect a proper balance between the objectives of facilitating SME capital formation and investor protection. By their interpretation and scope, the existing exemptions do not properly reflect the capital formation needs and requirements of SMEs, frustrating SME financing activities in circumstances where the underlying regulatory objectives are not relevant or, if relevant, are outweighed in the circumstances by the objective of facilitating SME capital formation. In many cases this is because the intentions of the drafters are not today borne out by the common usage of those exemptions. As outlined above, some of the exemptions have proved to be impractical and others are simply out of date.

D. Marketing

Subject to the restrictions described below, marketing of securities in the exempt market by registrants is generally permitted, because trades, including those in the nature of solicitations of expressions of interest or other acts in furtherance of a sale, are, by definition, exempt from the prospectus requirements. The principal limitation on marketing rights is in section 32 of the Regulation, which prohibits reliance on the "$150,000 exemption" in respect of trades made through an advertisement of the relevant securities in printed media of regular and paid circulation unless an offering memorandum with a contractual right of action is delivered to the purchaser. Draft National Policy 43 (discussed in greater detail in Part V.C below), despite the fact that it relates primarily to advertising of securities during the "waiting period" between the issuance of receipts for the preliminary and final prospectus and that the CSA stated in the notice accompanying the publication of Draft National Policy 43 that it decided not to deal specifically with its concerns regarding advertised private placements, is nevertheless relevant and warrants mention in this part. Draft National Policy 43 provides that the principles that it enunciates apply to all "Advertisements" (including Advertisements

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69 Specifically, we propose that clauses 35(2)10 and 72(1)(a), (c), (d), (l), (p) and subsection 72(2) of the *Securities Act* and subsections 14(b), (c), (d) and (f) and sections 27, 28, 31 and 32 of the Regulation be eliminated.

relating to distributions under a prospectus exemption and Advertisements related to trading in the secondary market).[70] Many of the advertising restrictions set forth in Draft National Policy 43 apply to any offering for which an "Offering Document" (which is defined to include not only prospectuses and preliminary prospectuses but offering memoranda and other mandated offering documents) is used. Under the proposed closely-held business issuer and accredited investor exemptions an Offering Document will not be required; accordingly, the provisions of Draft National Policy 43 would not apply. However, if a formal offering document is prepared restrictions parallel to those in Draft National Policy 43 (e.g. advertisements must refer to the offering document and must not contain information not in the offering document, and marketing materials can only be delivered to investors receiving the offering document) should apply. In general, the Task Force recommends that the liberalization of securities marketing reflected in Draft National Policy 43 should be equally applicable to exempt offerings made to accredited investors. The growing variety of marketing media may facilitate SME capital formation and should be accessible to SMEs seeking to raise equity capital without requiring the preparation and delivery of an offering memorandum with prospectus-like disclosure (thereby undermining the benefits of the prospectus exemption).

E. Investment Matching Services

Nature and History of Investment Matching Services

Obtaining access to "love money" does not present a problem for SMEs, as the sources of such capital are clearly well known to the entrepreneur. However, access to the suppliers of capital in the "angel" market may be more difficult. As described in Part III.B above, the "angel" market is an active market and the pool of "angel" capital is potentially very large. Nevertheless, as a practical matter it may be difficult for SMEs to locate willing or interested suppliers of "angel" capital to bridge the gap between suppliers and users of SME equity capital in the exempt market. To bridge that gap a number of investment matching services have developed.[71] The services provided by these matching services vary

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70 Draft National Policy 43 defines "Advertisement" very broadly to include information that it disseminated by or on behalf of an issuer, selling securityholder or registrant to persons or companies other than registrants by virtually any media that promotes or reasonably could be expected to promote a trade of specific securities.

71 Among the investment matching services currently operating in Ontario are: Business Centurions Centres Inc., a private sector initiative operating in Toronto with the goal of linking SMEs with experienced managers and entrepreneurs; The Investment Exchange, a computer matching service operating in Toronto and Calgary; VentureLinx Corporation, the successor to the Computerized Ontario Investment Network

dramatically, but generally speaking, the services offered by Canadian matching services are as follows:

1. Counselling: Counselling services are provided to assist entrepreneurs in developing a business plan and promotional materials and in assessing their capital needs.[72]

2. Screening: The matching service will evaluate the adequacy of the entrepreneur's business plan to determine if the investment opportunity is of suitable quality for inclusion in its data base.

3. Matching: A data base of "angel" investors (in some cases limited to investors who qualify for the $150,000 exemption), categorized according to their investment preferences and patterns (including the investor's sectoral or niche interests, the size of the investment the individual wishes to make and whether the individual is interested in assuming a managerial role), is maintained. Information on opportunities which meet the profile of the subscribing investor's interests will be provided to that subscribing investor.

Some investment matching services also hold regular investment fora to which prospective investors are invited and investment opportunities are showcased. Most investment matching services primarily perform a consultative and/or introductory role. Once the issuer is deemed marketworthy (which may only be after the matching services helps the issuer develop and refine its business plan) and the issuer and a potential investor have been introduced, they are typically left on their own (with the assistance of lawyers and accountants) to negotiate the terms of the investment. These investment matching services are only indirectly involved in sales and/or the provision of investment advice; they typically rely on consulting and/or membership fees more than on commission from sales. A variation on

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("COIN") operating in Toronto under the supervision of the Ontario Chamber of Commerce; LinkAge Management Inc., a St. Catharines, Ontario consulting company that provides an investment matching service among its various consulting services, and; the Specific Investment Opportunity Program, administered by the Ottawa-Carleton Economic Development Corporation, which provides various business advisory services including investment matching.

72 See Diane Francis, "Corporate 'Midwife' Helps Give Birth to Baby Enterprises", Financial Post, July 18. 1996, p. 13 for a discussion of the need for mentoring of entrepreneurs by angel investors and a description of an organization called the Competitors set up to counsel entrepreneurs and to facilitate investments in start up enterprises.

this type of service is provided by matching services which style themselves as exchanges. These organizations will typically pre-screen issuers proposing to "list" on the exchange, require some form of standardized disclosure for an electronic or other form of database, and permit investors to gain access to the database or payment of a subscription fee.[73]

At the other end of the spectrum are investment matching services which participate more directly in sales of securities and/or in advising others as to investments. These services perform a function more closely akin to that of registered dealers who happen to specialize in the SME niche.

To the extent that the matching services meet the definition of "market intermediary",[74] they are not permitted to rely on many of the exemptions from registration requirements without discretionary relief. Moreover, to the extent that the counselling services ancillary to the match-making business, such as the giving of advice regarding formulation of a business plan, likely constitute acting as an adviser within the meaning of the *Securities Act*, such activities cannot be engaged in without registration or discretionary relief.

In the past, discretionary relief has been granted by the Commission to investor matching services. In 1986, a ruling was granted to COIN (the Computerized Ontario Investment Network) exempting COIN from the registration requirements of the legislation.[75] However, under the terms of the ruling, COIN was restricted from playing a role in "screening" investment opportunities, and was precluded from playing an "investment advisory role with respect to network participants". As a result, COIN could neither provide entrepreneurs with feedback on their business plan nor weed out clearly unworkable proposals. Moreover, COIN could not tailor a list of investment opportunities to the interests of potential investors. These services are considered by many as fundamental to the success and viability of matching services, and some of the parties involved in or familiar with the operations of COIN cite the restrictive conditions of the ruling as a factor in its demise.

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[73] An example of a service proposed to be operated in this fashion is The Global Private Equity Exchange ("GPEX").

[74] As described in Part IV.A above, many of the exemptions from the registration requirements of the *Securities Act* are unavailable to parties who fall within the definition of "market intermediary".

[75] (1986), 9 OSCB 6496, November 28, 1986.

An additional issue arises because of the self-characterization by some investment matching services as "exchanges" and because of the exchange-like activities engaged in by a number of such services. Subsection 21(1) of the *Securities Act* prohibits any person or company from carrying on business as a stock exchange unless recognized by the Commission. To date, the only exchanges recognized by the OSC for this purpose are the TSE (which extends to CDN) and The Toronto Futures Exchange. Accordingly, if the activities being engaged in by investment matching services constitute or include the carrying on of a business as a stock exchange within the meaning of the legislation, then such activities are being conducted in contravention of the legislation. Unfortunately, there is very little guidance as to the meaning of the phrase "to carry on business as a stock exchange". The most often cited source for defining the activities of a stock exchange is the notice of the Securities and Exchange Commission (the "SEC") in the matter of Delta Government Options Corp.[76] The Task Force believes that some regulatory guidance as to what constitutes the "carrying on of a business as a stock exchange" would be instructive to investment matching services and to other service providers (by giving some indication of the types of businesses or activities in respect of which OSC recognition would be required); nevertheless, the SEC's decision in Delta Options is, in our view, an appropriate and (in the absence of any definitive guidance) useful starting point, and it would appear based on the reasoning in that decision that the activities engaged in by investment matching services presently operating in Ontario would not constitute the carrying on of business as a stock exchange.

In our view, investment matching services of the type described above should be encouraged, as they may help bridge the gap between users and suppliers of SME equity

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76 55 FR 1890, 1990 WL 338767 (F.R.). In Delta Options, the SEC was faced with the question of whether a system proposed by Delta Government Options Corporation ("Delta") and others to provide a central clearing facility for over-the-counter trading of options on U.S. treasury bills was an exchange within the meaning of applicable U.S. securities legislation. In its application to the SEC, Delta represented that it would be the issuer of all options traded on the system (it would simultaneously buy a corresponding option to offset its exposure) and would perform the following functions: (i) setting admission criteria for participants in the system; (ii) enforcing the system's rules and procedures; (iii) setting margin requirements, trading limits and position limits; and (iv) making determinations concerning supervision of participants. Trades would be effected on Delta's system either on a blind basis (i.e. an impersonal trade with no pre-trade negotiation or contract between buyer and seller) or following negotiation based on trading interest disseminated in the system; both types of trades would be reportable to the system. The SEC acknowledges that several functions performed by Delta were similar to those performed by a traditional exchange market, including participant admission decisions, the authority to establish trading rules and to impose position limits, providing a process for clearance and settlement of transactions, dissemination of prices, ability to set transaction fees, authority to establish "standardized" option terms and right to discipline participants and to suspend trading in the system. Nevertheless, the SEC determined that those functions were not unique to exchanges, and that the defining characteristic of an exchange is that of a marketplace in which participants can expect to receive executions, on a regular or continuous basis, on both the buy and sell sides of a particular market.

capital. As noted above, certain of the activities engaged in by these services may constitute technical violations of securities legislation. The Task Force recognizes that such investor matching services may not be viable unless certain ancillary counselling and investment advisory services (including those to which registration requirements of the *Securities Act* would apply) are provided. However, we are concerned that providing a blanket exemption to the activities of investor matching services would provide too broad an opportunity to circumvent the registration requirements of the legislation. The Task Force is aware that certain services are presently being offered and could potentially be offered through Internet[77] and similar media which might be characterized as computerized investment matching services but which are in fact "boiler-room" type sales activities, i.e. high pressure mass marketing services marketing securities to unsophisticated investors.

Recommendations For Reform

The Task Force understands that several investment matching services have limited their subscriber (i.e. investor) base to sophisticated investors (i.e. investors who meet prescribed net worth or other criteria, usually defined with reference to applicable private placement thresholds). The Task Force believes that investment matching services of the nature described above that limit their clientele to accredited investors should be exempt from the legislation's registration requirements; in those cases concerns about unsophisticated investors not having the benefit of the involvement of a registrant are mitigated and do not warrant denial of the potential benefits provided by those services.

In its Proposal for Comment the Task Force attempted to develop criteria for a broader exemption for investment matching services (i.e. services not limited to accredited investors), and specifically requested comment on an exemption for all investment matching services registered with the Ministry of Economic Development, Trade and Tourism (Ontario) and/or for services that:

(i) are sponsored by a governmental or quasi-governmental agency, chamber of commerce or board of trade;

(ii) operate on a cost recovery, not-for-profit basis; and

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77 The potential for trading securities on the Internet, and a description of some of the on-line services presently being provided, is set forth in "Trading on the 'Net", Insight Press, June 24, 1996.

(iii) charged fees consisting solely of membership or subscription fees (as opposed to transaction-oriented "success fees") which do not vary based on the size or success of the proposed transaction.

These criteria were uniformly rejected in the comment letters received. Commentators were sceptical of the benefits of governmental sponsorship (especially in an era of governmental belt-tightening) and in particular stressed that without the ability to charge transaction fees either subscription fees would become uneconomically high or the services would not be able to recover costs. For the reasons expressed above the Task Force does not believe that a blanket exemption for all investment matching services would be appropriate. Given the wide variety of services offered, and the difficulty in developing universally applicable criteria for identifying services that should be exempted from registration requirements, the Task Force has concluded that the services which involve non-accredited investors should be examined and, if appropriate, exempted by the Commission on a case-by-case basis.

V. SMALL PUBLIC OFFERINGS

A. Disclosure Regarding a Public Offering

One of the most significant elements of cost in the public offering process is the direct and indirect costs of preparing and qualifying the prospectus itself. The existing disclosure requirements for prospectuses, and the instructions as to how prospectuses must be prepared, are widely dispersed among a variety of regulatory instruments. The instructions themselves tend to be very technical and occasionally vague, such as to require a high degree of experience and expertise to interpret and apply them. Moreover, many of the required disclosure items are, in the Task Force's view, irrelevant to SMEs and their investors. As a consequence, the preparation of an SME prospectus is more time-consuming and expensive, the quality of prospectuses submitted to the OSC is poor (and the review process is therefore longer), and the final documents are less useful to and comprehensible by SME investors. The burden of the costs of prospectus preparation and qualification falls disproportionately on SMEs, as discussed in Part III.C above.

B. Recommendations for Reform

1. We recommend the development and adoption of a revised prospectus form (the "Small Business Prospectus Form") which utilizes a simplified question and answer format and includes comprehensive instructions concerning completion of the form. The disclosure requirements of the new form would be oriented to issues relevant to SMEs and/or to investors in SMEs. The Small Business Prospectus Form could only be used by an issuer with not more than $10 million in gross revenues in its most recently completed financial year and with market capitalization (calculated on a fully-diluted basis prior to the proposed offering) of not more than $35 million. There would be no limit on the amount of money which could be raised using the Small Business Prospectus Form. SMEs would have the right, but not the obligation, to use the Small Business Prospectus Form, with its SME-tailored disclosure requirements, rather than the general prospectus form.

The principal considerations motivating the Task Force's recommendation to develop the Small Business Prospectus Form were to make the form easier to prepare, more relevant to SMEs and more user-friendly to SME investors. As a general matter, these ends would be accomplished by: (i) including a comprehensive and understandable set of instructions, with commentary and examples; (ii) eliminating disclosure items which are not relevant to SMEs; and (iii) adopting a question and answer format (these recommendations are discussed in greater detail below). The Task Force understands that a new prospectus form and a comprehensive set of prospectus disclosure requirements and instructions are being currently developed (as part of the OSC's ongoing reformulation process). Although the new form will not be tailored to SMEs, it may resolve certain of the Task Force's concerns about the non-consolidation and dated requirements of the existing forms and about the quality of the instructions.

The Task Force recognizes that some SMEs may have reason to prefer the general prospectus form to the Small Business Prospectus Form. For that reason, the use of the Small Business Prospectus Form, with its SME-tailored disclosure requirements, would be optional rather than mandatory.

The Task Force has not defined the specific disclosure requirements of the Small Business Prospectus Form. Those disclosure requirements, and the principal differences between the existing prospectus forms and the proposed Small Business Prospectus Form, may be generally described as follows:

1. SMEs typically have short operating histories, and offerings of equity in SMEs are typically sold on the basis of a concept or the prospect of growth, together with a dedicated management team or other strong sponsorship. Historical information, including historical financial statements, is generally of limited relevance when assessing an investment in an SME. The costs of compiling some of that information can be significant and, in our view, outweigh the benefits of disclosure of that information, particularly since in respect of an SME such information is often immaterial. Consequently, the Small Business Prospectus Form should generally require less in the way of disclosure of historical information. In that context, we believe that the revised prospectus form should require more detailed disclosure concerning forward-looking information such as business plans, obstacles anticipated in realizing business goals and overall strategy (a fuller discussion of the Task Force's views concerning disclosure by SMEs of future oriented financial information is set forth in Part VI hereof). An example of what we believe to be appropriate tailoring of a small business offering document to the SME market would be required disclosure about the intended use of all of an enterprise's available capital as opposed to just the proceeds of the offering.

2. We expect that the most significant reductions in disclosure requirements will occur in the presentation of historical financial statements, both in respect of the issuer itself and in respect of significant acquired businesses. Currently, an SME preparing a prospectus is required to include statements of operations and deficit, surplus and changes in financial position for each of the last five financial years (or such shorter period as the Director permits or requires) and any part of a subsequent financial year to the date of the most recent balance sheet in the prospectus, together with a balance sheet as of a date not more than 120 days prior to the date of the issuance of the receipt for the preliminary prospectus, or such other date as the Director may permit or require, and as at the corresponding date of the previous financial year.[78] The Task Force understands that as part of the OSC's ongoing reformulation process the Commission has accepted OSC staff's recommendation to reduce the five year financial statement disclosure requirement described above to three years. Each financial statement as at a year end or for a full financial year must be audited. In addition, financial statements for "stub" periods (i.e. periods of less than a full financial year after the end of an issuer's last completed financial year) and comparative periods must be audited unless, subject to the Director's discretion, the stub period ended not more than 90 days before the date of issuance of the receipt for the preliminary prospectus and not more than one year after the issuer's last audited financial year.

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78 Under existing requirements where the most recent balance sheet included in a prospectus is as at a date other than a financial year end, the issuer need not include a balance sheet as at the corresponding date of the previous financial year provided that the prospectus contains a balance sheet as at the most recent financial year end and as at the immediately preceding financial year end, pursuant to subsection 53(2) of the Regulation.

Section 53(6) of the Regulation provides that where the Director is satisfied that there is sufficient justification, he or she may permit the omission of any of the required financial statements. The Director has on occasion used this ability to waive, in the case of SMEs, the requirement for audited financial statements for the three or four least current of the five required financial years so that the issuer need only incorporate an audited balance sheet as at the end of the previous fiscal year and audited statements of operations and deficit, surplus and changes in financial position for the two most recently completed financial years. This waiver has generally been given where it was not practical for more audited financial information to be obtained and the additional information was considered to be of limited relevance. The Task Force is of the view that costs to issuers could be substantially decreased without compromising meaningful disclosure by codifying this practice. The Task Force understands that historical audits for SMEs, which are often performed *ex post facto*, are difficult, time-consuming and expensive and do not provide materially better disclosure for SMEs than auditor comforted statements; the Task Force further believes that for issuers with very short operating histories and minimal revenues, the principle benefit of auditor involvement is the discipline of the process rather than the production of financial statements for periods not very recently ended. In addition, the Task Force believes that although it is essential that audited financial statements be provided by an issuer raising money in a public offering, historical numbers for SMEs are generally less relevant and consequently an appropriate balance between the cost to the issuer and the provision of meaningful information to an investor requires the inclusion of only audited financial statements for the prior fiscal year if that is all that is available. However, it was felt that, in order to enhance the investors' understanding, unaudited financial statements for the immediately preceding period (comforted by the SME's auditors in the manner presently required for all unaudited financial statements included in prospectuses pursuant to subsection 65(3) of the Regulation) should be presented for comparative purposes in those circumstances. Accordingly, we recommend that the Small Business Prospectus Form require (subject to the Director's discretion) the inclusion of an audited balance sheet for only the most recently completed financial year (the "Most Recent Year") and audited statements of operations, deficit or surplus and changes in financial position for only the most recently completed financial year, provided that where audited statements for the year immediately preceding the Most Recent Year are available (i.e. the statements have been audited and the issuer's auditor has either issued a "clean" opinion on those financial statements or has issued an opinion with reservations made in compliance with National Policy Statement No. 50 of the CSA), such statements would have to be included in the issuer's prospectus. In addition, issuers would of course be permitted to include audited financial information in excess of the minimum requirements should they wish to do so for marketing or other purposes. Where only one year's audited statements would be included in a prospectus, unaudited financial statements (covered by an auditor's review engagement

report) as at and for the immediately preceding year (or other appropriate period) would be required for comparative purposes.

With respect to financial statement requirements for "stub" periods, the Task Force recommends that a prospectus using the Small Business Prospectus Form be required to include the then most recent interim financial statements filed or required to have been filed (as if the issuer were, if it was not, a reporting issuer throughout the relevant period) by the issuer with the Commission (except where then more current annual statements are required to be included in the prospectus), together with comparative statements for the comparable period of the Most Recent Year, which statements need not be audited (any unaudited statements would be required to be covered by an auditor's review engagement letter). This recommendation is intended to alleviate the hardship imposed by the existing "stub" period financial statement disclosure requirements that cause unaudited interim financial statements to become outdated after 90 days for prospectus disclosure purposes, which effectively means that if a prospectus is filed early in an issuer's quarter the interim financial statements may have to be prepared for a period (and/or on a schedule) that does not correspond to the issuer's quarterly reporting cycle. The Task Force's recommendation in this regard, under which interim financial statements would remain current for prospectus disclosure purposes until the next following period's statements are prepared or required to be prepared, would not disrupt issuers' financial reporting cycles.

With respect to significant acquired businesses, subsection 56(1) of the Regulation requires that where the proceeds of the securities offered by a prospectus are to be applied in whole or in part to finance the acquisition of a business, the Director may permit or require the inclusion in the prospectus of:

(i) financial statements of the acquired business consisting of one or more of certain of the financial statements required in respect of the issuer itself for the same time periods; and

(ii) a *pro forma* balance sheet combining the assets and liabilities of the issuer and the business as shown by the respective balance sheets each as of a date not more than 120 days prior to the date of the issuance of a receipt for the preliminary prospectus or such other date as the Director may permit or require.

Moreover, subsection 56(1) states that the Director may require *pro forma* statements combining, year-by-year, the income or losses of the business with the income or losses of the issuer and the changes in financial position of the business with the changes in financial

position of the issuer for a period not more than one year immediately preceding the date of the balance sheet.

Paragraph 23 of OSC Policy Statement No. 5.1 ("OSC Policy 5.1") elaborates as to how this discretion will be exercised; that provision presently requires that where the proceeds of an offering are to be used to acquire a business, the prospectus must include balance sheets for the two most recently completed years of the acquired business, together with a balance sheet within 120 days of the day of the prospectus if the year end is not within 120 days, and statements of operations, deficit or surplus and changes in financial position for the acquired business for each of the last three financial years of that business and for any part of a subsequent year of the acquired business up to the date of the most recent balance sheet in the prospectus. More liberal requirements are generally applied to SMEs if such statements are not available. For the reasons expressed above the Task Force recommends that the acquired business financial statement prospectus disclosure requirements applicable to SMEs should balance the materiality of the proposed acquisition to the issuer, the difficulty in obtaining the required audited information and the ability to make sufficient disclosure to investors through alternative means such as unaudited information and/or narrative disclosure, bearing in mind the reduced financial statement disclosure requirements applicable to the issuer itself under the Small Business Prospectus Form.

3. Disclosure items that are considered to be unusable, irrelevant or confusing to SME investors, such as the current requirement relating to calculation and presentation of a dilution ratio, would not be mandated (the Task Force understands that the dilution ratio requirement will be eliminated as part of the Commission's reformulation process).

4. The form would adopt a question and answer format similar to the format utilized in the Small Corporate Offering Registration System ("SCOR"), which system was originally developed in Washington State in 1982 and has to date been adopted by 41 states.[79] The form is specifically designed to permit small business persons to complete the form (at least initially) without professional assistance and to improve the consistency and comprehensibility of small business offering disclosure to investors. A survey of issuers under this SCOR system was completed by the Small Business Sales Practices Committee of NASAA in

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79 This format has also been adopted by the Securities and Exchange Commission (the "SEC") for certain offerings under Regulation A (this exception permits distributions of not more than U.S.$5 million to be made by an issuer in any 12-month period without registration where an offering statement in prescribed form has been qualified with the SEC) under the Securities Act of 1933 and the Securities Exchange Act of 1934. See Federal Securities Law Reports, "Additional Small Business Initiatives", CCH para. 85, 134, May 5, 1993. Adoption of a SCOR-like form for SME offerings has been proposed by a number of commentators, including Professor MacIntosh (see. p. 149 of the MacIntosh Report).

September, 1993.[80] The surveyed issuers listed the principal advantages of a SCOR process as: (i) significant portions of the offering documents were handled in-house with consequential savings in legal and accounting fees; and (ii) the disclosure resulting from the SCOR process was more meaningful for the average investor when presented in a simplified question and answer format. The Task Force reviewed the new prospectus forms recently developed in other jurisdictions using the traditional (i.e. non-question and answer) format and, although laudable and material improvements have been made in those cases, the Task Force determined that the question and answer format would offer significant and worthwhile benefits, as described above.

5. As noted above, the Small Business Prospectus Form would incorporate a comprehensive and comprehensible guide to disclosure requirements, including cross-references to and excerpts from the *Securities Act*, the Regulation and relevant rules (or policies where appropriate).[81] The form will contain illustrative examples and incorporate commentary on deficiencies that OSC Corporate Finance staff routinely raise. We expect that complaints about the delays in receiving comments on preliminary prospectuses filed by SMEs should be reduced by the new Small Business Prospectus Form since its disclosure guidelines and commentary should improve the quality of preliminary prospectuses submitted, thereby expediting the review process.

6. Similar to the form employed in the SCOR system, the new Small Business Prospectus Form will include suggested risk disclosure language. The form will permit this language to be tailored by an issuer to meet its particular business circumstances or omitted if appropriate. The provision in plain language of suggested risk factor disclosure should assist an issuer in preparing, and less sophisticated investors in understanding, the prospectus.

7. Of course, the issuance of a receipt for a prospectus prepared using the Small Business Prospectus Form would continue to be subject to the Director's discretion pursuant to section 61 of the *Securities Act* to refuse to issue a receipt where it appears to the Director not to be in the public interest to do so. A list of bases for the exercise of the Director's discretion in this regard is set forth in subsection 61(2) of the *Securities Act*.

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80 Report on SCOR Survey - Small Business Sales Practices Committee, September, 1993.

81 This approach is consistent with the approach adopted by the BCSC in its Form 12A for use by junior industrial issuers.

We believe that the adoption of the Small Business Prospectus Form should:

(a) facilitate the provision to SME equity investors of disclosure which is more comprehensible and more relevant to their investment decision;

(b) simplify the prospectus preparation process and reduce the costs to SMEs attributable to that process by providing a form that SMEs can substantially complete through greater use of in-house resources and less reliance on professional advisers; and

(c) reduce the regulatory review period and the number of comments (by structuring the form more closely to the finished product expected by security regulators, with detailed commentary on the relevant disclosure requirements and common deficiencies, thereby improving the quality of information included in the initial preliminary prospectus filed with regulators and saving both issuers and regulators time and money).

The Task Force determined that the disclosure accommodations provided by the Small Business Prospectus Form should not be afforded to non-SMEs. As noted in Part II.C above, SMEs are defined for this purpose to mean issuers with both (i) gross revenues not exceeding \$10 million during the previous fiscal year, which is consistent with the threshold adopted in the exemptions to OSC Policy Statement No. 5.10, and (ii) market capitalization (calculated on a fully-diluted basis prior to the proposed offering) of not more than \$35 million.[82] Larger issuers (such as issuers resulting from government privatizations or corporate spin-offs) have the necessary resources to present audited financial statements for the prior five years and other detailed information, and in many cases such information is of significant relevance to potential investors. Although there will be no specified minimum amount of money that must be raised under an offering using the Small Business Offering Prospectus, the Task Force would not anticipate that SMEs would find it appropriate to file a Small Business Offering Prospectus if they intended to raise less than \$2-3 million. The Task Force does not consider it necessary to impose other restrictions on the ability of an issuer to use the new prospectus form, such as a limitation on the offering price of the securities or the maximum amount of money that can be raised, since the Task Force expects that disclosure prepared in accordance with the new form will in fact, be "better" than disclosure which complies with current requirements in most cases.

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[82] A more fulsome discussion of these thresholds is set forth in Part II.C above.

C. "Marketing Securities"

Aside from certain solicitations permitted in the context of a bought deal,[83] which are applicable only to issuers participating in the prompt offering qualification system, issuers are not permitted to market securities to potential investors prior to the filing of their preliminary prospectus. Issuers are therefore prevented from soliciting indications of interest or otherwise gauging potential investor receptiveness to a public offering before incurring the expense of preliminary prospectus preparation. The scope of permissible advertising activities is also limited during the "waiting period", i.e. the period between the issuance of a receipt for a preliminary prospectus and the issuance of a receipt for the final prospectus. Under the *Securities Act* and Uniform Act Policy 2-13, "waiting period" marketing is basically limited to distributing the preliminary prospectus and soliciting expressions of interest if, prior to each solicitation or forthwith after the prospective purchaser indicates an interest in purchasing the security, a copy of the preliminary prospectus is delivered to such prospective purchaser.[84] These limited activities can only be engaged in by a registrant since they fall within the legislation's definition of a "trade". Advertisements may be placed in a newspaper during the waiting period by a registered dealer; such advertisements may identify the security, state the price of the security (if then determined), state the name and address of a person or company from whom purchases of securities may be made and solicit expressions of interest in the securities. A bold-faced legend in prescribed form must be included in the advertisement, which legend states that a preliminary prospectus has been filed, that the advertisement does not constitute an offer to sell, and that no sale may take place before a receipt is issued for the final prospectus.[85] Recently the subcommittee on advertising appointed by the CSA published for comment a revised Draft National Policy 43,[86] which would permit advertising of securities through a broad range of media (including print, radio, television, telemarketing, public promotions and investor meetings) during the "waiting period" provided that the advertisement is not misleading in any way and generally not prejudicial to the public interest. The draft policy requires that any advertisement contain a conspicuous reference to the offering document, that marketing documents not include any information not in the offering document and that a marketing document cannot be delivered to an investor who does not

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[83] A bought deal is a transaction where underwriters commit to purchase an issuer's securities at a specified price before the filing of a preliminary prospectus. See the blanket ruling, In the Matter of National Policy Statement No. 47 and the Solicitation of Expressions of Interest, June 9, 1993 (1993), 16 O.S.C.B. 2832.

[84] See subsection 65(2) of the *Securities Act*.

[85] See Uniform Act Policy No. 2-13.

[86] Supra, footnote 56.

have or concurrently receive the offering document. The general U.S. federal regulatory scheme for pre-filings and "waiting period" marketing is substantially similar to the existing Ontario framework. Commentators have suggested that the inability to "test the waters", i.e. to ask retail investors if they are interested in purchasing securities of an SME before the issuer incurs the full cost of preparing a preliminary prospectus, is a significant disincentive to SMEs raising equity in public markets.[87] Both the expense of preliminary prospectus preparation and the embarrassment of an aborted public offering due to lack of investor interest can be significant.

In an effort to respond to these concerns, the SEC determined in 1993 to permit issuers relying upon the Regulation A exemption to solicit indications of interest prior to filing the mandated offering. The content of the materials used to "pre-market" the securities are not specified, although they must include statements to the effect that, among other things, no consideration is being solicited and that no binding agreement or commitment of any kind can be made before delivery of the offering statement. The solicitation material is permitted to be published in any print media or broadcast or radio and/or television; however, the materials or script must first be provided to the SEC. Sales of the advertised securities are not permitted until 20 days after the last use of the solicitation materials. However, this SEC liberalization was not widely available because many of the American states did not adopt comparable rules. More recently, the SEC has announced that it is considering allowing emerging companies intending to make an initial public offering by prospectus to "test the waters"; these considerations are apparently at a very early stage.[88]

The NASAA, motivated by similar considerations, is studying a proposal to permit testing of the waters at the state level.[89] The proposed rule would permit pre-preliminary prospectus solicitations where:

(i) ten days prior to the initial solicitation, the offeror files a prescribed solicitation of interest form along with any other materials to be used to conduct solicitations of interest;

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87 See the MacIntosh Paper at pp. 127-129.

88 Jeffrey Taylor and William Power, "Firms Could Test Waters For IPOs Under SEC Plan", *Wall Street Journal*, May 2, 1995, p. C1.

89 North American Securities Administrators Association, Inc., "*Proposed Statement of Policy on Solicitation of Interest (Testing the Waters)*", NASAA Reports, CCH 1994, ¶4141.

(ii) no material which the offeror has been notified by the relevant securities regulatory authority not to distribute is used to solicit indications of interest;

(iii) during the solicitation of interest period, the offeror does not solicit or accept money or a commitment to purchase the security;

(iv) no sale is made until seven days after delivery to the purchaser of a prospectus; and

(v) the offeror does not know and, in the exercise of reasonable care, could not know that the issuer and any of its officers, directors or significant shareholders or promoters has recently been charged, under investigation or convicted of fraud or other securities-related offences.

2. We recommend that the rule against pre-marketing be modified to permit issuers whose securities are not publicly traded to test the market for their securities prior to the filing of a preliminary prospectus.[90]

The Task Force, motivated by the considerations described above, is of the view that pre-preliminary prospectus solicitation should be permitted. However, the Task Force cautions that testing the waters is likely to be less advantageous in Ontario than in the United States because the smaller number of dealers and potential investors in the Canadian marketplace typically means that the issuer and its dealer will have a relatively good understanding of the probable demand for securities of the issuer, certainly by the dealer's institutional clients and probably by its retail clients. The ability to test the waters may permit more accurate pricing of an SME's securities which should result in a reduction in the cost of capital to SMEs; however, because estimations of market demand and of an appropriate price for securities of an SME which are not listed or otherwise actively traded is as much an art as a science, the decrease in the cost of the capital resulting from information gained through the testing of the waters may be limited. The limitation that only first-time prospectus issuers be permitted to test the waters has been imposed because the existence of an active market for securities of the issuer should assist the issuer in estimating the demand for its securities, and because the existence of an active trading market may provide an opportunity for those solicited in

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90 This proposal parallels Professor MacIntosh's recommendation at pp. 128-9 of the MacIntosh Report.

advance of a preliminary prospectus to exploit for profit their knowledge of the intended issuance.[91]

Pre-preliminary prospectus solicitations would be subject to restrictions such as those being considered by NASAA, including a requirement to pre-file any materials to be used to solicit indications of interest, a prohibition on accepting money or commitments to purchase during the solicitation period, and a requirement that no sale be made until seven days after the delivery to the purchaser of a prospectus. Although no statutory civil liability would attach to the solicitation materials, those pre-marketing materials would be subject to the same restrictions as would apply to other marketing materials under Draft National Policy 43 (i.e. the disclosure cannot be misleading). The distribution of misleading information would be a factor taken into consideration by the Director in the exercise of discretion pursuant to clause 61(2)(e) as to whether to issue a receipt for a prospectus.

With respect to the proposed expansion of the scope of permitted activities during the "waiting period" described in Draft National Policy 43, the Task Force believes that such expansion is a positive and necessary step to facilitate SME equity capital formation. The Task Force believes that marketing opportunities such as investor meetings are both necessary for many SMEs seeking to raise equity capital and appropriate, provided that suitable emphasis is placed on the availability of the preliminary prospectus and that the nature and substance of advertisements made are monitored to ensure that no misleading information is included in them.

D. The Prospectus Delivery Requirement

The *Securities Act* requires that a prospectus be delivered to each purchaser of securities. Some commentators have argued that this requirement should be eliminated on the basis that the delivery requirement imposes a significant and unjustifiable cost on issuers. The Task Force recognizes that many investors do not review delivered prospectuses in their entirety, if at all, relying on registered salespersons, the dealers' research departments or sophisticated investors to review the disclosure. Nevertheless, the present view of most of the members of the Task Force is that, at least until SEDAR (the System for Electronic Document Analysis and Retrieval, an electronic filing system) is fully implemented,[92] the benefits of

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91 See pp. 127-129 of the MacIntosh Report.

92 Implementation of SEDAR is currently scheduled for early 1997. See CSA Request for Comments: Notice of Proposed National Instrument - SEDAR (1996), 19 OSCB 2345 and OSC Notice re SEDAR (1996), 19 OSCB 5101.

the delivery requirement outweigh its costs.[93] The delivery requirement is the primary mechanism by which the prospectus disclosure is disseminated in the marketplace; the legislative scheme is premised on investment decisions being made based on information in the prospectus. The expectation of the Task Force is that reforms such as the adoption of the Small Business Prospectus Form will enhance the utility of prospectuses and, consequently, the degree to which they are read and relied upon by investors. On the cost side, the Task Force notes that prospectus delivery systems are already in place; moreover, the Task Force believes that the costs of printing sufficient copies for delivery is only marginally higher than printing a smaller number of copies to be made available to interested investors, as the bulk of printing cost is in the set-up stages.

E. Auditors' Liability

An auditor's liability for misrepresentations in a prospectus generally arises from two sources:

(i) the common law, under which an auditor may be considered to owe a duty of care to those investors whom the auditor knows to be relying on the audited financial statements for the purpose of a particular transaction; and

(ii) section 130 of the *Securities Act* which, as described in Part IV.A above, expands the scope of common law liability by providing a right of action for damages and/or rescission without the necessity of proving reliance, subject to certain defences. As discussed in Part IV.A above, defendants (including auditors) subject to statutory civil liability are jointly and severally liable, and there is a right of contribution except where contribution would not be just and equitable.

Section 34 of the Regulation requires an auditor who is named as having prepared or certified any part of the prospectus or as having prepared or certified a report used in connection with a prospectus to file a written consent to being named in the prospectus and to the use of the report in the prospectus; by virtue of that certificate an auditor is subject to statutory civil liability under clause 130(1)(d) of the *Securities Act* with respect to reports, opinions or statements made by it. Under subsection 34(3) of the Regulation, the consent required must contain a statement that the auditor has read the prospectus and has no reason

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93 A contrary view is expressed by Professor MacIntosh at pp. 124-126 of the MacIntosh Report.

to believe that there are any misrepresentations in the information contained therein that is derived from the financial statements upon which the auditor reported or that is within the auditors' knowledge as a result of the audit of such financial statements, which suggests that an auditor may be responsible for portions of the prospectus which it did not prepare. This responsibility for the entire document is consistent with accountants' professional standards: they are associated with, and therefore responsible for, the entire prospectus. Because the Small Business Prospectus Form will continue to contain audited financial statements, auditors will continue to be subject to the liabilities described. Generally, underwriters and their counsel, became (among other reasons) of their statutory civil liability for misrepresentations, subject to a due diligence defence, carry out significant due diligence to ensure that the entire prospectus contains full, true and plain disclosure.

However, as discussed in Part VIII.C below, the Task Force is proposing that underwriters' statutory civil liability for misrepresentations in a prospectus prepared by an SME be eliminated. Consequently, there may be a greater chance that misrepresentations will occur in a prospectus, particularly outside the financial statements, and, in the event a misrepresentation is alleged or discovered in a prospectus, the underwriters may not be subject to the same degree of liability to which they are presently subject. In addition, the TSE Committee on Corporate Disclosure has proposed that liability attach to all continuous disclosure documents which would, among other things, extend statutory civil liability remedies to investors who purchase securities in the secondary market and which would thereby increase the scope of potential auditors' liability.[94] The TSE Committee on Corporate Disclosure has proposed that each defendant to a statutory action for misrepresentations be liable only for its proportionate share of any damages unless the plaintiff can prove that the defendant intentionally made the misrepresentation.[95]

Because these possible changes may increase auditors' risk of liability in being associated with an SME prospectus, it might also increase the cost of their involvement.

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[94] Supra, footnote 68.

[95] Ibid., at para. 6.40.

3. The Task Force recommends that auditors be liable only for their proportionate share of damages awarded to a plaintiff in a statutory civil action for misrepresentation in an offering document prepared using the Small Business Prospectus Form.

In the Proposal for Comment the Task Force proposed amending the prescribed form of auditors consent to delete any statements as to the auditor having read the prospectus and having no reason to believe that there are any misrepresentations contained therein. While the Task Force recognized that the proposal, if implemented, may not have had the effect of reducing auditors liability, we were and are concerned about that liability if no underwriters are involved and, as a consequence, the auditors are the sole remaining "deep pocket" defendant. In circumstances where there is a limited number of solvent potential defendants, a regime of joint and several liability, with a right of contribution, will typically result in a disproportionate degree of liability being imposed on the solvent defendant(s). The Task Force believes that a more effective means of accomplishing this objective, which has the benefit of being consistent with the proposals of the TSE Committee on Corporate Disclosure, is to adopt a system of proportionate liability (with the portion of liability corresponding to the defendant's portion of fault as assessed by a court). The sole exception would be where it is proven that one or more defendant(s) intentionally made a misrepresentation or delayed disclosure, in which event such defendant(s) should be jointly and severally liable if a damage award is not fully satisfied.

F. Statutory Civil Liability

As noted in Part IV.A above, the *Securities Act* expands the scope of common law liability that would attach to a misrepresentation in a prospectus. Investors who purchase securities under a prospectus have a statutory civil liability remedy.[96] Under the present regulatory framework, investors who purchase securities in the secondary market, even while those securities are still in primary distribution, do not have a statutory civil liability remedy.

Resolution of this issue involves questions which go well beyond the Task Force's mandate, and the Task Force makes no specific recommendations in this regard. Nevertheless, although the Task Force is sensitive to the need to encourage public disclosure by SMEs, the Task Force is supportive of the principle of responsibility for continuous disclosure reflected in the interim report of the TSE Committee on Corporate Disclosure.

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[96] See section 130 of the *Securities Act*.

G. Continuous Disclosure Requirements

Once an issuer has obtained a receipt for a final prospectus from the Commission, that issuer becomes a "reporting issuer" within the meaning of the *Securities Act*, thereby becoming subject to a variety of continuous disclosure obligations. Those disclosure obligations include the obligation to prepare and annually distribute to shareholders audited financial statements and information circulars concerning the annual meeting or to file an annual report in accordance with Form 28 under the Regulation. Issuers that have revenues of $10 million or less as reported in their most recent annual financial statements need not prepare and file an annual information form with the OSC in accordance with OSC Policy Statement No. 5.10. A further set of continuous disclosure requirements is set forth in subsection 77(1) and section 79 of the *Securities Act*, which provide that every reporting issuer prepare and file interim quarterly financial statements (which need not be audited) and distribute such statements to its securityholders.

Much of the expense associated with delivering interim financial statements to shareholders is alleviated by National Policy Statement No. 41 of the Canadian Securities Administrators ("National Policy 41"). Under National Policy 41 issuers who duly maintain a supplemental mailing list[97] are exempt from the interim financial statements delivery requirements of most provinces, including Ontario, in certain cases subject to the fulfilment of certain specified conditions, provided that the statements are filed as required with relevant securities regulatory authorities and stock exchanges.

OSC Policy Statement No. 2.6 ("OSC Policy 2.6") sets forth guidelines under which the OSC will generally grant discretionary relief to reporting issuers from the obligation to file and, to the extent the issuer is not otherwise exempted by National Policy 41, distribute quarterly financial statements. Part I.A of OSC Policy 2.6 states that the Commission will be inclined to grant orders exempting an issuer from the requirement to file interim financial statements with the OSC and to distribute such statements to its securityholders "where the issuer demonstrates that the preparation and distribution of such statements would not be of significant benefit to investors and would represent a material financial burden to the issuer." OSC Policy 2.6 goes on to state that the Commission is prepared to grant on a routine basis a full exemption where the issuer has working capital of $50,000 or less and, where a full exemption from the interim financial statement requirements of legislation is not justified, the OSC will consider granting a partial exemption exempting the issuer from the applicable

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97 Issuers are required under National Policy 41 to include in the annual distribution of year-end materials a return card permitting its security holders to request that they be placed on the issuer's supplemental mailing list. Issuers are required to deliver interim statements to all persons listed on their supplemental mailing lists.

requirements with respect to the first and third quarters of each financial year. The Commission, through OSC Policy 2.6, has recognized that there are circumstances, particularly with respect to issuers which are relatively dormant or which have very stable and predictable financial operations and results, where the cost of the interim financial statement preparation, filing and distribution requirements outweighs the related benefits. Exemptions from these requirements typically terminate upon the occurrence of a material change, whereupon a renewal application must be made.

The Task Force does not recommend any changes to the interim financial statement requirements described above as they apply to SMEs. Although in the Proposal for Comment we proposed that SMEs be exempt from the requirements to file and distribute to its security holders interim financial statements for the first and third quarters of each financial year, the majority of the Task Force is persuaded that the benefits of these requirements outweigh the associated costs. It is clear that any information concerning an SME in the first year following its initial public offering is valuable to the marketplace, given that there may be little information in the marketplace about the SME and because SMEs during that stage of development may be undergoing dramatic changes. The requirement to prepare and file unaudited interim financial statements should not be unduly onerous, since all issuers will presumably prepare financial statements at least quarterly, if not monthly or on an even more frequent basis. As to the distribution requirement, much of the cost of this requirement is alleviated by National Policy 41 (as discussed above), and in any event the Task Force believes that the cost of distribution is a short term issue which should be resolved through the implementation of SEDAR and increasing reliance on the electronic transmission of information. To the extent that relief is warranted, the Task Force believes that application should be made under OSC Policy 2.6.

VI. FUTURE ORIENTED FINANCIAL INFORMATION

A. Existing Regulatory Regime

The manner in which publicly disclosed future oriented financial information ("FOFI") must be prepared, disclosed, dated, subsequently compared with actual results and up-dated is set forth in National Policy 48. The guidelines set out in National Policy 48 apply to prospectuses, preliminary prospectuses, offering memoranda used in connection with offerings under the $150,000, seed capital and government incentive securities exemptions described above and certain other documents. National Policy 48 provides that in ordinary circumstances the period covered by FOFI shall not extend beyond the end of the issuer's next

financial year (i.e. a maximum of 24 months). Publicly disclosed FOFI must be prepared in accordance with the requirements of the handbook of the Canadian Institute of Chartered Accountants and, where included in an offering document, must be accompanied by an auditor's report. In addition, the public disclosure of FOFI requires that the issuer engage an auditor to provide a "comfort letter" filed with the relevant securities regulatory authorities stating that the assumptions underlying the FOFI are reasonable in the circumstances and that the disclosed FOFI is consistent with the assumptions made. In most circumstances publicly disclosed FOFI must be in the form of a forecast, based on assumptions which reflect the issuer's planned courses of action given management's judgment as to the most probable set of economic conditions for the period covered by the forecast. Where an issuer is engaged in a business with less than two years' operating history it may be permitted to present its FOFI in the form of a projection, which unlike a forecast may include and be based upon hypotheses that are consistent with the issuer's intended courses of action and which represent plausible circumstances; projections entitle the issuer to illustrate the expected effect of various courses of action and economic conditions which are plausible but not necessarily most probable and permit FOFI to be expressed in the form of ranges of anticipated results, rather than a specific figure.

Once FOFI has been publicly disclosed, the issuer must compare the FOFI with its actual results achieved in every continuous disclosure document filed thereafter during the period covered by the FOFI, and the issuer must disclose the nature and impact of any change which occurs in the events or in the assumptions used to prepare the disclosed FOFI that has a material affect on such FOFI.

B. Practical Problems Faced by SMEs

SMEs often have a difficult time complying with National Policy 48. SMEs normally do not have systems in place designed to budget or forecast future results and the nature of most SMEs' activities makes forecasting inherently difficult. These and other factors also make auditing an SME's FOFI time consuming, difficult and costly. Occasionally, an audit firm is unable to express an audit opinion on an SME's FOFI and, consequently, the SME is precluded from including FOFI in its prospectus.[98] Moreover, the inability to express FOFI in the form of projections constrains SME issuers, particularly where the business, although it has been operating for more than two years, is not firmly settled. In

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[98] Professor MacIntosh has suggested that the FOFI audit requirement might be eliminated. See pp. 126-127 of the MacIntosh Report.

general, the Task Force believes that it is desirable to have FOFI included in the prospectuses of SMEs and that reforms may be necessary to facilitate this.

There have been on-going debates in Canada and other jurisdictions regarding the desirability of having FOFI included in offering documents and the issues associated with its inclusion. Such issues include whether FOFI should be permitted or mandated in offering documents and whether auditor involvement is necessary or useful. Staff of the Commission has completed two surveys tracking the actual operating results of selected public companies that had previously used FOFI in connection with prospectus distributions and is presently conducting another survey. The more recent survey,[99] which was conducted in 1993 and which covered all issuers that included FOFI and prospectuses during the period from July 15, 1989 to December 31, 1990, indicated that FOFI figures for revenues and net earnings tended to significantly exceed actual results. This finding, which was consistent with the results of a previous survey conducted in 1990,[100] was found to be particularly true for issuers classified as "start-up issuers", generally defined as issuers with less than 2 years of operating history.

C. Deliberations of the Task Force

The Task Force discussed the results of previous surveys with staff of the Commission and provided views on the use of FOFI by SMEs to Commission staff. The Task Force understands that staff of various Canadian securities regulatory authorities are presently considering changes to National Policy 48; accordingly, the Task Force is not proposing changes to the FOFI regime applicable to SMEs at this time. Generally, however, the Task Force believes that substantive restrictions (such as an audit requirement or a limitation of the use of projections) should not be imposed on FOFI used in connection with offerings made under the closely-held business issuer or accredited investor exemptions. Disclosure regarding the considerations in assessing FOFI should be included in the generic information statement referred to in Part IV.C above if FOFI is provided. The Task Force believes that FOFI is generally more important for SMEs than for larger enterprises, since past performance is generally less relevant to a SME's anticipated performance. At the same time, the requirements of National Policy 48 impose a relatively greater burden on SMEs since SMEs will often have more difficulty preparing FOFI and auditing the FOFI will be time-consuming and costly, if it can be audited at all. As a result, the Task Force believes that reform is

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99 See "FOFI and Prospectus - An OSC Staff Survey" (1994), 17 OSCB 6, January 7, 1994.

100 "Forecasts in Prospectus - An OSC Staff Survey" (1990), 13 OSCB 707, February 16, 1990.

necessary. More frequent use of ranges for FOFI by SMEs might mitigate the above problems and also result in more appropriate FOFI being presented. Consideration should also be given to developing approaches to FOFI that would eliminate the requirement that FOFI be audited and allow greater use of projections (as opposed to forecasts). It is not the Task Force's intention to suggest that any relaxation of substantive FOFI requirements should be counterbalanced by enhanced substantive review of FOFI by Commission staff. It has been pointed out that the potential for abuse through the presentation of FOFI is greater for SMEs, particularly SMEs in early stages of development, since there is no track record against which the FOFI can be measured; in fact, it is this very characteristic of SMEs that makes even the most diligently and responsibly prepared SME FOFI likely to be a less than perfect prediction of future performance. Accordingly, any reform of the FOFI requirements should balance: (i) the importance of FOFI to SME investors and the consequential need to facilitate FOFI presentation; (ii) the need to impose discipline on unreasonable FOFI by means that do not present insurmountable obstacles to SME issuers; (iii) the characteristics of SME issuers that warrant flexibility in the types of FOFI permitted to be disclosed, particularly with respect to the use of projections; and (iv) the propriety of communicating the nature of FOFI and the difficulty in projecting SMEs' future performance to investors.

VII. ESCROW REQUIREMENTS

A. Existing Regulatory Regime

Pursuant to subparagraph 61(2)(f) of the *Securities Act*, the Director is prohibited from issuing a receipt where such escrow or pooling agreement as the Director considers necessary or advisable with respect to the offered securities has not been entered into. The circumstances in which the Director will consider an escrow of securities of an industrial company to be necessary or advisable, and the general guidelines governing regulatory escrows, are as set forth in OSC Policy 5.9.[101] Generally, an escrow will only be required where an issuer files its first prospectus in Ontario.[102]

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[101] Although the OSC and the TSE have separate escrow requirements (the TSE's escrow requirements are set forth in its Founder Stock Policy Statement), each provides an exemption to issuers which comply with the requirements of the other body. Subject to the discretion retained by both bodies to impose stricter requirements where necessary, an issuer is free to comply with the less restrictive requirements.

[102] Escrow agreements for issuers other than natural resource companies are required to be made in accordance with Form 18 unless the Director permits (or encourages) variation.

Traditionally, escrow requirements were regarded as having one or both of the following purposes: (i) to ensure that the promoters of an offering did not benefit at the expense of the public investors but rather were required to maintain a certain amount of their investment in the issuer until such time as it could be determined whether or not the description in the prospectus of the issuer's plans and prospects of future growth was accurate; and (ii) to "lock in" management so as to ensure that they had an incentive to devote their time and attention to the issuer since the investor is relying on those individuals to carry out the plans described in the prospectus and the investor's purchase of stock is to a large extent based on her confidence in management's experience and abilities. The first rationale is clearly reflected in the existing regulatory regime which provides, as described below, that only those shares which insiders had received for consideration which is deemed insufficient or which is not represented by net tangible assets in the business at the time of the public offering are escrowed. As such, promoters of an offering are prevented from inviting the public to invest in an issuer and then cashing in their stake in that issuer for assets contributed to the issuer by the public. The concept that an escrow is also necessary to lock in management is reflected to a much lesser extent in OSC Policy 5.9. One illustration of this is the fact that the Commission has historically granted requests for transfers within escrow provided that the persons to whom management was transferring the securities appeared to have some experience and ability to carry out the plans described in the issuer's initial prospectus, even though they were not necessarily the individuals who originally formed the management of the issuer at the time of the offering. Because the ability of management to transfer its securities is in the discretion of the Commission, it is difficult to say the extent to which this latter principle is currently reflected in the policy. The Task Force understands that it is the "cheap stock" consideration described in (i) above that has predominantly influenced administrative practice in this area with little emphasis on "locking in" management.

The escrow requirement applies to "equity securities" (defined in OSC Policy 5.9 to mean, generally, residual equity shares) beneficially owned or over which voting control is exercised by promoters of the issuer, directors and/or officers holding more than 5% of any class of equity securities, and significant (over 10%) shareholders of any class (collectively, "Related Security Holders").[103] Because the escrow requirement applies to significant

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[103] Perhaps the most significant difference between OSC Policy 5.9 and the TSE's escrow requirements is that under the TSE's Founder Stock Policy Statement there are certain prescribed circumstances, including where the issuer had a 2% pre-tax return on shareholders' equity in the full fiscal year preceding the offering and current profitability at the time of the offering (where the return or equity is for the same type of business for which funds are being raised), where the issuer will be exempt from the central requirements in the TSE's policy. In those circumstances, the TSE has discretion to impose an escrow on shareholders who are involved in management of the issuer or who hold sufficient shares to affect materially the control of the issuer, which may be a smaller group than Related Security Holders. The TSE escrow policy employs a similar formula, using the net tangible value to calculate the size of the

shareholders, providers of significant amounts of pre-public offering equity capital, such as venture capital investors, are sometimes caught.

Under OSC Policy 5.9 a shareholder who is required to escrow shares may be entitled to a certain number of "free" shares, i.e. shares not subject to escrow. The number of "free" shares is a function of the equity contributed to the issuer by the shareholder, calculated based on the value of the issuer's net tangible assets and upon the consideration paid by the shareholder for his or her securities.[104]

Subparagraph 38(1)3 of the Regulation provides that, where an escrow agreement is required for an industrial company before a receipt for a prospectus is issued the promoters may receive, free of escrow, securities equal in value to the aggregate of the cash and the fair market value of such tangible assets as are acceptable to the Director that such promoters have transferred to the issuer.

Under the present regulatory regime, there is no requirement that each Related Security Holder participate in the escrow arrangements to the same extent (this again demonstrates the degree to which the rationale of "locking-in" management is not reflected in the policy); the TSE rules also permit disproportionate escrow. As such, one Related

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escrow. Net tangible assets are divided by the net offering price per share, with the quotient number of shares, referred to as "value shares", being exempt from escrow.

104 This calculation is made using two tests:

(a) **Securities represented by net tangible assets** - to be calculated according to the following formula:

$$\frac{\text{Number of Shares Owned} \times \text{Net Tangible Assets per share}}{\text{Offering price to the public}}$$

(b) **Securities for which consideration is sufficient** - to be calculated on the basis of the original price per share and the time elapsed from the date of acquisition of that share to the date of receipt for the preliminary prospectus. Under this rule, the following shares would not be subject to escrow:

1. shares acquired more than one year prior for a consideration equal to at least 60% of the offering price;

2. shares acquired more than two years prior for a consideration equal to at least 45% of the offering price; and

3. shares acquired more than three years prior for a consideration equal to at least 25% of the offering price.

Security Holder could agree to escrow more than required so that another could have all or a larger percentage of his, her or its shares free from escrow. As such, an investor could negotiate for a less onerous escrow if the principals of the enterprise were prepared to accept a disproportionately high escrow of their securities.

Once escrowed, shares may not be sold, assigned, pledged, transferred or otherwise in any manner dealt with without the written consent of the Director of the Commission except as may be required by reason of the death or bankruptcy of the relevant shareholder. Releases from escrow occur according to a prescribed schedule. Ten percent of the securities subject to escrow are released nine months after the receipt for the final prospectus. Thereafter, shares are released on the anniversary of the first release according to a schedule which varies based on the nature of the security and on the number of securities escrowed.[105] All releases are to be made *pro rata* among the Related Security Holders unless they agree otherwise in writing.

An exemption is available from the escrow requirements of OSC Policy Statement No. 5.9 if the net earnings per share (fully diluted) for the five preceding fiscal years aggregate at least 50% of the price per share to the public. As noted above, a further exemption from those escrow requirements is available if an escrow agreement has been entered into pursuant to the Founder Stock Policy Statement of the TSE; conversely, the TSE waives compliance with its escrow requirements where an issuer has complied with the OSC's escrow requirements.

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105 The release schedules are as follows:

(i)	If the shares qualify as "legal for life":	-	45% after each of the first and second anniversaries of the initial release
(ii)	If the number of escrowed shares is not more than thirty percent (30%) of the number of equity shares outstanding after the offering:	-	30% on each of the first, second and third anniversaries of the initial release
(iii)	In all other cases:	-	20% on the first, second and third anniversaries, and 30% after the fourth anniversary of the initial release

The TSE's escrow release schedule is set forth in Table B to the Founder Stock Policy Statement. The TSE's release schedule differs from that under OSC Policy 5.9 in two respects: (i) the schedule depends only on the percentage of shares escrowed, and not on whether the shares are "legal for life"; and (ii) the schedule permits "earned releases", which are early releases based on the attainment of a specified cash flow per share levels.

B. Market-Induced Escrow Requirements

In cases where regulatory or stock exchange escrows are not applicable, the underwriters may have concerns about ensuring that the insiders of the issuer do not quickly exit after completion of the offering. These concerns reflect both an effort to provide that the underwriters' clients are presented with a sound investment opportunity and the desire of the underwriters to ensure that they are able to sell the securities offered under the prospectus (so as to extinguish their underwriting liability) before the existing shareholders sell their securities. The underwriters' costs of market stabilization during the course of the distribution can be artificially inflated by sales during the distribution or shortly thereafter by insiders. In such cases, in order to preserve the post-offering market, the underwriters may negotiate a voluntary escrow agreement with the insiders and/or all existing shareholders of the issuer.

Release schedules applicable to such voluntary escrow arrangements are typically much shorter than regulatory release schedules and are usually subject to change with the underwriters' consent. Frequently all securities are released from escrow within 90 days of the closing of the offering since a primary purpose of the escrow is to facilitate the distribution and the consequential market stabilization.

C. Problems with the Existing Framework

It is the view of the Task Force that, while the escrow requirements in the existing regulatory regime enhance minority investor protection by ensuring that such investors are not asked to assume an unconscionable portion of the downside risk, the requirements suffer from three significant flaws:

1. the provisions governing required regulatory escrows in general, and particularly the provisions governing the calculation of the number of shares subject to escrow, are exceedingly complex;

2. the burden of the escrow arrangements is borne disproportionately by certain types of SMEs, particularly high technology SMEs, which typically lack significant net tangible assets and therefore receive fewer "free" shares; and

3. the rational basis for certain of the distinctions which determine the escrow release schedule, such as the "legal for life" status of the relevant securities, is

not apparent, and such distinctions only indirectly relate to the object of the escrow requirement themselves.

In addition, the Task Force believes that the escrow release schedules under the existing regulatory regime are longer than necessary to accomplish the objectives of those requirements and pose a significant and unwarranted cost and disincentive on public offerings in Ontario.

D. Recommendations for Reform

1. The regulatory escrow requirements should be changed in the following respects:

(a) The credit for net tangible assets should be eliminated from the calculation of the number of shares subject to escrow requirements, and clause 38(1)3 of the Regulation (which permits promoters of offerings to receive shares free of escrow based on the value of net tangible assets which they have transferred to the issuer) should be repealed.

The elimination of the credits for contributions of net tangible assets will have the effect of simplifying the escrow requirements, and will also level the playing field for enterprises with little or no net tangible assets.[106] We believe that the estimates of net tangible assets fail to accurately estimate the value of the enterprise or of the contributions of Related Security Holders.

(b) The escrow release requirements should be standardized for all issuers, to provide that one-third of the shares are free from escrow, one-third are to be released nine months after the closing date of the offering, and the remaining one-third are to be released on the later of eighteen months after the closing date and one week after the filing of the issuer's first post-offering audited annual financial statements.

This amendment will again have the effect of simplifying the escrow requirements. This amendment will also eliminate distinctions based upon considerations not

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106 The de-emphasis of the importance of net tangible assets in escrow calculations has been recommended by Professor MacIntosh. See pp. 114-115 of the MacIntosh Report.

directly relevant to the objectives of the escrow requirement, such as the status of an issuer as a "legal for life" issuer.[107]

The Proposal for Comment recommended that the escrow period be shortened to one year, which was considered by many commentators as too liberal. Although the Task Force still believes, for the reasons expressed in Part VII.C above, that the release schedules must be accelerated, the Task Force is persuaded that the escrow period should extend past the time at which a set of audited financial statements for the period during which the issuer has been a reporting issuer would normally be available, which will permit the marketplace to become somewhat familiar with the issuer and which should provide some indication of whether or not the business concept described in the prospectus can be achieved. The Task Force believes that the recommended release schedule is of sufficient length to ensure (to the extent reasonable in the circumstances) that the promoters of an offering do not undeservedly benefit at the expense of the public investors and that management stays with the issuer and has incentive to implement the plans for the issuer described in the prospectus.

In its Proposal for Comment the Task Force also proposed that disproportionate sharing of escrow obligations not be permitted, because proportionate sharing would require angel investors who may have expertise in financing matters (and whose continuing participation may therefore benefit SME issuers) to stay with the issuer longer than they otherwise might, because disproportionate escrow arrangements often complicate the application of escrow requirements, and because proportionate sharing did not seem unduly onerous (and therefore not a material impediment to investment by venture capitalists) in view of the proposed accelerated release schedule. However, the Task Force is now of the view (shared by many of the commentators on the Proposal for Comment) that disproportionate sharing of escrow obligations and transfers of escrowed securities among Related Security Holders with the consent of the Commission should continue to be permitted, particularly in view of the recommended extension of the escrow release schedule to eighteen months. We are persuaded that disproportionate sharing does not unduly complicate escrow arrangements and that the right to disproportionately share escrow requirements may have the beneficial effect of attracting experienced angel investors to an issuer in the more precarious pre-offering stage.

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[107] Legal for life standards such as that incorporated into the existing escrow requirements have been replaced as the appropriate investment standard in most federal and provincial legislation governing the activities of financial institutions. The standard, which required a record of dividends and/or earnings over a specified threshold for a given period, was essentially meaningless as it simply rewarded non-qualifying issuers who were able to acquire a qualifying shell.

Clearly, the reforms proposed will only be meaningful for issuers proposing to list on the TSE if the TSE permits escrow agreements entered into pursuant to the new system to be exempt from the TSE's escrow requirements.

The reforms proposed with respect to the escrow requirements would apply equally to all SMEs, including junior natural resource issuers, because for reasons described in Part XI below we recommend that there be no separate sectoral strategies and that existing sector-specific regulatory regimes, such as OSC Policy Statement 5.2 which applies to junior natural resource issuers and which contains its own escrow requirements, be repealed.

In all other respects, the Task Force proposes that the current escrow requirements remain in effect, unamended.

VIII. REGISTRATION REQUIREMENTS

A. Existing Regulatory Regime

The *Securities Act* generally provides that no person shall trade in securities or underwrite issuances of securities unless the person is registered.[108] The purpose of the registration requirements, generally, are to provide some assurance to investors as to the reliability and the quality of the services of the securities market actors with whom they are dealing. Dealers and their registered staff serve many roles in connection with an offering of securities, several of which constitute essential underpinnings of the securities regulatory regime. These functions are foundations upon which both the investor protection and market integrity and efficiency objectives of the securities regulatory framework are based. The three principal roles or functions of dealers are as follows:

(a) Underwriter: This role, performed by a registrant's corporate finance staff, involves the provision of advice to issuers concerning available financing opportunities, participation in the structuring of an offering and conducting due diligence.[109]

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108 See subsection 25(1) of the *Securities Act*. The registration requirements are discussed in greater detail in Part IV.A of this Report.

109 As discussed in Part IV.A above, the legislation imposes civil liability on underwriters for misrepresentations in the prospectus, subject to a number of defences including the "due diligence" defence which provides that underwriters cannot be held liable for misrepresentations in a prospectus unless, *inter*

(b) Market-Maker: Performed by a registrant's trading staff, this task involves ensuring (to the greatest extent practicable) an orderly distribution of offered securities and a liquid after-market; and

(c) Professional Sales: Performed by institutional and retail sales staff, this role involves the provision of professional investment advice, including research, to investors, based on the financial goals and risk tolerance of each investor.

In any discussion of whether the registration requirements as they presently apply to the raising of equity by SMEs are necessary or appropriate, it is important to analyze each of these functions separately. In our view, much confusion had resulted in the past from the failure to distinguish between the benefit of a dealer's liability for misrepresentations in an SME prospectus and the benefit of a dealer's advice to a potential investor concerning the suitability of an investment in securities of an SME.

There is no requirement for issuers quoted on CDN (the CDN market and others are discussed in Part X below) to have a market-maker. However, we understand that the new last-trade reporting system implemented on CDN is available only for issuers with a market-maker. The reason for this is that, unlike the TSE and other Canadian exchanges, CDN does not have contractual relationships with participating issuers; instead, CDN has contractual relationships with only the market-makers. Consequently, CDN must require issuers to have a market-maker in order to effectively operate its last-trade reporting system. Because of the enhanced visibility offered by the last-trade reporting system, and the obvious benefits and attractiveness of that system to investors and their advisors, there may be a *de facto* requirement for issuers quoted on CDN to have a market-maker.

B. Practical Problems Faced by SMEs

There appears to be a generally held view that, with few exceptions, Canadian dealers have little inclination to assist SMEs in raising equity capital, whether this be in an underwriting capacity, as market-makers in actively promoting the purchase by their clients of securities in SMEs or even in analyzing these types of investment opportunities on their

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alia, they "failed to conduct such reasonable investigation as to provide reasonable grounds for a belief that there has been no misrepresentation". The net effect of these provisions is consistent with their clear purpose: underwriters conduct such due diligence investigations as they consider necessary to satisfy themselves that there is no misrepresentation in the prospectus, thereby providing some assurance to investors that the disclosure in the prospectus is "full, true and plain" and that the underwriters stand behind the document.

clients' behalf. This may be due to the comparatively small scale of the Canadian market, which has apparently hampered the development of a regional dealer network and of dealers specializing in smaller offerings.[110] Full service dealers may be reluctant to participate in smaller offerings because the costs (including the disproportionate high costs of due diligence, the possible exposure (economic and reputational) arising from involvement in smaller, riskier deals and the cost of locating and advising suppliers of SME capital) are perceived to outweigh the benefits. Moreover, the information asymmetry which characterizes the entrepreneur/dealer relationship increases the relative costs to SMEs of registrant involvement in the prospectus process.

In its Proposal for Comment the Task Force proposed that the requirement that a registrant be involved in a public offering by an SME in its professional sales role be eliminated. As noted above, the purpose of this requirement is to ensure a level of investor protection by having the dealer assess whether or not the investment is suitable for the individual investor. Registered sales representatives, who are subject to a "know your client" obligation and are therefore required to understand their clients' investment objectives, can play an important role in assessing the suitability of an investment for their clients. The Task Force was concerned that the retention of the sales representative would be anomalous if no underwriter was involved, particularly if some dealers were not prepared to handle SME securities and SME issuers would therefore be compelled to place their securities with a small number of dealers (which would put SME issuers at a bargaining disadvantage). However, the Task Force believes that dealer involvement will be dictated by the demand side (i.e. the investors). For that reason, because as a practical matter most investors in an SME public offering will invest through a dealer, and because of the benefits of the involvement of a professional sales representative (as outlined above), the Task Force is now of the view that the requirement to involve registered sales representatives should be retained.

C. Recommendation for Reform

Faced with the apparent general disinclination of the dealer community to participate in the financing of SMEs, the Task Force examined whether and how the requirements for dealer involvement could be eliminated or modified without significantly sacrificing investor protection or a fair and efficient marketplace. Our recommendations are as follows:

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110 See the MacIntosh Paper at pp. 140-142.

1. **We recommend the requirement that any underwriter involved in a public offering sign a certificate in the prospectus prepared stating that to the best of its knowledge, information and belief, the prospectus contains no misrepresentation, which is the source of underwriters' statutory civil liability under section 130 of the *Securities Act*, not apply to SME prospectuses.**

As discussed in Part IV.A above, the OSC does not presently interpret the *Securities Act* (and in particular section 59 thereof) as requiring that an underwriter be involved in a prospectus offering; rather, the legislation is interpreted as requiring only that any underwriter(s) involved in such an offering sign the prospectus. Our recommendation goes one step beyond this, in that the requirement for an underwriter's certificate would be eliminated for SME prospectus offerings even where underwriters are involved. Consequently, underwriters would not be subject to statutory civil liability for misrepresentations in an SME's prospectus.

The Task Force recognizes and acknowledges the benefits of underwriter involvement in the prospectus process, including the interposition of a sophisticated third party to determine whether it is appropriate to bring the issuer to market and to conduct due diligence; it is equally clear that eliminating underwriters' liability will eliminate an existing remedy available to aggrieved investors. However, these benefits, which where emphasized by a number of commentators, are not a "free good" and must therefore be carefully considered and weighed against the corresponding costs. The Task Force believes that because of the cost:benefit equation meaningful underwriter involvement in SME public offering is relatively rare, and it may even be that the apparent involvement of an underwriter where such involvement is not meaningful is more misleading to investors than it is beneficial. Measured against the disproportionately high cost of due diligence for SMEs, the higher proportion that such costs represent of an SME public offering and the apparent degree to which the need to involve an underwriter has been an obstacle to SME public financings, the benefits of the registration requirement do not, in the Task Force's view, justify its cost or the impediment it has imposed. The decision as to whether or not an issuer chooses to engage a dealer in assisting it in marketing its securities should be left to the discretion of the SME and the demands of potential investors; this result cannot be achieved if dealers are statutorily required to assume any statutory liability for a misrepresentation in the prospectus. To impose statutory civil liability on a dealer assisting an SME in raising equity capital while at the same time providing that dealer involvement is not necessary may well create a material disincentive for dealer involvement, a result which the Task Force does not wish to cause.

It has been suggested that SME public offerings cannot be sold without underwriter involvement, and in particular without dealer due diligence; this is ironic, since the Task Force considers the relative paucity of SME public financings (and the popularity of reverse take-over bids, by which issuers have "gone public" through a structured transaction involving a publicly held shell company rather than by way of a prospectus offering) to be evidence of the undesirable effects of the underwriter liability requirement. The Task Force believes that the elimination of statutory civil liability for underwriters, to the extent that it facilitates public financings by SMEs, will be particularly important as the rules governing reverse take-over bids are tightened (the Task Force understands that under proposed new rules a prospectus may effectively be required for reverse take-overs.) Earlier in this Report, we referred to the recommendation that a standard information document be delivered to each non-accredited investor who acquires securities under the "closely held business issuer" exemption. The Task Force concluded that the cautionary language included in this document should be sufficient to alert unsophisticated investors to the need to address the suitability of the investment given their own investment objectives. For similar reasons, the Task Force proposes that language be included in the small public offering prospectus where applicable which addresses the fact that no underwriter was involved in the prospectus process and that consequently the benefits of independent third party review and liability for the disclosure in the prospectus are not afforded to investors.

2. **We further recommend that, in the context of exempt market transactions, the registration requirement should be eliminated for SMEs and their officers and directors.**

The Task Force recommends that the concept of universal registration, to the extent that it requires every person or company who acts as a market intermediary to be registered with the Commission, be retained, but that issuers, together with their directors and officers, be permitted to sell securities of their own issue without the need to be registered provided that no commission or other transaction-related remuneration is paid by the issuer to any of its directors, officers, employees or any others in connection with the sale of its securities. The basis for this recommendation is our belief that in the exempt primary market for SME securities the decision as to whether the interposition of a registrant is necessary or appropriate should be left to the issuer and to the marketplace. If, however, a dealer (i.e. someone other than the issuer and its directors and officers who acts as a market intermediary) is involved, that market intermediary should be required to be registered.

In addition, we recommend that the "limited market dealer" category of registrant be eliminated as it relates to SME financing. In the Task Force's view, this category of registration has not served to promote the achievement of any regulatory objectives in connection with SME equity financing, primarily because to date no significant educational, proficiency or capital requirements have been imposed on limited market dealers. The Task Force recognizes that there are many limited market dealers whose activities are not related to SME financing; implementation of this recommendation would likely necessitate a review and recategorization of such dealers' activities.

In summary, the Task Force proposes that the concept of the universal registration be maintained to the extent that persons who are engaged in the business of buying and selling securities be required to be registered with the Commission, but that whether or not a dealer is involved in offering the securities of an SME be left up to the issuer and its potential investors. The impact of universal registration on SMEs be specifically addressed in any formal consideration of reform.

IX. HOLD PERIODS

A. Problems with the Closed System

Generally, the securities legislation's "closed system" prevents the unrestricted sale of securities of any issuer which is not a reporting issuer. In addition, it requires that securities of a reporting issuer which were acquired under one of the prospectus exemptions be held for a period of time before they may be freely resold (the "hold periods").[111] The inability of a purchaser of securities of an SME to sell the securities to whomever he or she wishes, whenever he or she wishes, is seen by some as the most significant reason why investors are reluctant to purchase securities of SMEs. Equity interests in SMEs are by their very nature illiquid. They tend to be speculative, hard to value, and rarely, if at all, traded. Obviously, the inability to freely resell securities of SMEs, which problem is exacerbated by the closed system, has a significant impact on the level of investor interest in purchasing such securities.[112] Since the Task Force shared the concerns of commentators that the "hold periods" are a significant impediment to the financing of SMEs, the Task Force examined the

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111 The length of the hold period in a given circumstance varies depending on the nature of the issuer, the nature of the vendor (if not the issuer) and the prospectus exemption pursuant to which the relevant securities were issued. A more detailed discussion of the hold periods is set forth in Part IX.B below.

112 See the MacIntosh Paper at pp. 106-114.

considerations underlying the closed system with a view to determining whether it could recommend that the restrictive nature of the hold periods be reduced without unduly compromising basic securities regulatory goals.

B. Existing Regulatory Regime

The Closed System

The closed system, which was introduced in part on September 15, 1979 and which became fully effective on March 15, 1981, is a finely tuned collection of regulatory provisions which, in concept, was "elegant".[113] However, the system has resulted in unforseen levels of uncertainty, complexity and expense.[114] It is badly in need of rethinking but does not lend itself to tinkering, i.e. recommending certain changes without addressing its conceptual underpinnings.

The rules of the closed system are numerous and complex; those rules are set forth in interdependent provisions in the *Securities Act*, the Regulation and blanket rulings (now deemed rules) of the Commission. For the purposes of this Report we intend to only briefly outline the principal features of the closed system; for a fuller understanding of that system reference should be made to the sources of the rules and to more detailed commentaries.[115] The resale of securities issued in reliance upon a prospectus exemption will generally be governed by one of three resale regimes, set forth in subsection 72(4), (5) and (7) of the *Securities Act*.[116]

The resale regime governed by subsection 72(7) applies to resales of securities by "control persons", which are generally defined to mean persons who alone or in combination hold a sufficient number of securities of the issuer to affect materially the control of that

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113 Making Continuous Disclosure Work Better, Remarks of Edward J. Waitzer, Chair, Ontario Securities Commission (1994), 17 OSCB 242 at 243.

114 Ibid.

115 See, for example, Drinkwater, Orr and Sorell, supra, footnote 37. Much of the discussion of the closed system in this portion of the Report is based upon that source.

116 With respect to securities issued pursuant to certain specific private placement exemptions, there is no applicable resale regime so that such securities cannot be resold other than by way of prospectus or in reliance upon a further prospectus exemption. See, for example, clauses 72(1)(o), 72(1)(r) and subsection 72(6) of the *Securities Act*.

issuer, with a 20% holding being deemed (absent evidence to the contrary) to be a holding sufficient to materially affect control of an issuer.[117] The other two resale regimes, set forth in subsections 72(4) and (5) of the *Securities Act*, govern resales by all other shareholders. The question as to which of these two regimes will apply is dependent upon the prospectus exemption pursuant to which the securities to be resold were initially purchased. For example, securities purchased pursuant to the prescribed institution, exempt purchaser, $150,000 and limited offering exemptions described above will be governed by the resale regime set forth in subsection 72(4); resales of securities issued pursuant to certain other prospectus exemptions, including the exemption that permits issuances in certain circumstances to employees of the issuer, will be governed by subsection 72(5). Subsection 72(5) also governs resales of securities of companies which have ceased to be private companies. The basic features of these two resale regimes are that a securityholder who has acquired securities in reliance upon a private placement exemption can resell those securities without qualifying a prospectus or relying upon a further prospectus exemption if, in addition to certain notice or disclosure requirements, the following conditions are met:

1. the issuer of the security is a "reporting issuer" (i.e. subject to the continuous disclosure obligations of the legislation) and is not in default of its statutory and regulatory obligations as such;

2. no unusual effort is made to prepare the market or to create a demand for the securities and no extraordinary commission or consideration is paid in respect of the resale; and

3. the shareholder must have held the securities for six, twelve or eighteen months (depending on the nature of the issuer and of the securities) from the later of the date of the purchase of the securities and the date on which the issuer became a reporting issuer.

The length of the hold period for resales governed by subsection 72(4) is 6 months where the securities are "legal for life" (i.e. eligible investments for insurance companies governed by the *Insurance Act* (Ontario)) and listed or posted for trading on a recognized exchange,[118] 12 months if the securities are listed or posted for trading on a recognized exchange, and 18 months in all other cases. Subsection 72(5) does not require that the securities have been held

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117 See clause (c) of the definition of "distribution" in subsection 1(1) of the *Securities Act*.

118 The exchanges presently recognized for this purpose are The Toronto Stock Exchange and The Montreal Exchange (see OSC Policy Statement No. 3.1, paragraph C).

by the vendor for a specified length of time; rather, that subsection provides that resales thereunder can only occur more than 12 months after the issuer becomes a reporting issuer.

The resale rules applicable to securities in the closed system held by securityholders who are "control persons" are set forth in subsection 72(7) of the *Securities Act*. A control person holding securities may resell them to another "control person"[119] or by qualifying a prospectus or relying on a further prospectus exemption. A control person who does not wish to proceed by any of these routes can, pursuant to subsections 72(7)(b) and (c) of the *Securities Act*, proceed by the "advance notice" process. Under that process a "control person" can proceed to sell securities in the closed system by giving advance notice to the OSC and to any stock exchange on which the securities are listed. The notice, which is required to disclose the particulars of the control position, the number of securities to be sold and the method of distribution (in accordance with Form 23 under the Regulation), must be given at least seven days and not more than fourteen days prior to the first trade to be made as part of the intended resale. To the extent that any securities intended to be distributed are not sold within 60 days of the original date of filing, the notice must be renewed; thereafter renewals must take place every 28 days. In order to use the "advance notice" process the following conditions must be met:

1. the issuer of the securities must have been a reporting issuer for a period of not less than 18 months and must not be in default of any of its statutory or regulatory obligations as such;

2. no unusual effort is made to prepare the market or to create a demand for the securities and no extraordinary commission or other consideration is paid in respect of such trade; and

3. the securityholder must represent that he or she is not selling with knowledge of any undisclosed material change in the affairs of the issuer.

In addition, under section 25 of the Regulation, the securities sold must have been held by the vendor for at least six months, and if any of the securities of the control person (whether they are the securities which are intended to be resold or not) of the class to be resold were acquired by that person in reliance on certain prospectus exemptions then none of the securities of that class can be sold until they have <u>all</u> been held for a period of six, twelve or eighteen months, depending on the nature of the securities. This section has generated what in our view are inappropriate and inequitable results. Control persons can avoid application

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119 See clause 14(b)(i) of the Regulation.

of the section by effecting their purchases through different controlled entities. However, control persons may not be aware of the effect of the section until they seek professional advice in connection with the proposed sale. Accordingly, we believe that this section should be re-examined as part of any reform of the closed system.[120]

Essentially, the closed system was introduced in an effort to ensure that securities were only freely traded in the public markets when information concerning both the issuer and the attributes of the security sufficient to allow an investor to make an informed investment decision was publicly known and available. Although many commentators have speculated as to the intent of the Legislature when imposing the various hold period requirements, the three commonly discussed reasons are outlined below. First, the imposition of hold periods prevents back-door underwriting in that an issuer or controlling shareholder is prevented from finding a "friendly" exempt purchaser who is willing to "notionally" purchase the securities with the intention of immediately reselling them to a non-exempt purchaser, thus avoiding the prospectus requirements. Second, the imposition of hold periods ensures that certain information about the issuer is properly disseminated. For reasons described in greater detail below, the Task Force believes that the prescribed hold periods are longer than required to properly disseminate information about an issuer in the marketplace and that the premise of requiring actual knowledge on the part of each potentially interested party before information is considered to be disseminated is inappropriate in today's marketplace. Third, the imposition of hold periods induces issuers to offer securities in a retail distribution by reducing the price buyers will pay for privately placed securities (since the securities are not freely tradeable) thereby increasing the supply of good quality investments available to the retail market. It is not certain whether or not this third rationale was an intended purpose, but it is clear that the hold periods have not proven to be particularly effective in causing issuers to sell securities under prospectuses rather than in private placements.

Special Warrant Transactions

As a result of the inability to qualify previously issued securities which are subject to hold periods under a prospectus, unless the securityholder had a present intention to sell them (ie. to sell them in a secondary offering under the prospectus itself), the investment community developed the concept of "special warrants".[121] In a special warrant transaction,

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120 The reform of subsection 25(2) of the Regulation is recommended in the MacIntosh Paper at pp. 113-114.

121 For further explanation of special warrant transactions and some of the problems resulting therefrom see the OSC Notice entitled "Use of Special Warrants in Connection with Distributions of Securities by Prospectus" (1989), 12 OSCB 2168.

an issuer issues special warrants in a transaction exempt from the prospectus requirements (usually pursuant to the $150,000 exemption or, less frequently, pursuant to the seed capital exemption) and then, once a receipt for a prospectus is obtained, the special warrants are converted into the underlying securities (typically common shares). The distribution qualified by the prospectus is the conversion of special warrants to common shares so that the common shares in the hands of the private placees are freely tradeable. The prospectus must be delivered to the holders of the special warrants (but not to persons who may purchase the common shares from such holder). The special warrant structure is the only exception to the rule that previously issued securities may not be qualified by a prospectus unless they are to be sold under the prospectus. We view special warrants as an exception because the proceeds from the issuance of the securities have generally already been transferred to the issuer at the time of the prospectus (although they may be escrowed).

Special warrants are a valuable financing tool because they allow issuers to sell securities quickly at a price which reflects the fact that the securities will be freely tradeable within approximately two months rather than approximately 14 to 20 months. The speed of special warrant transactions allows an issuer to lock in a price for securities and access ready buyers when the market is receptive to an offering of its securities. If an issuer cannot effectively obtain commitments until after it has prepared and filed a preliminary prospectus which has been reviewed and commented upon by securities regulators, the issuer may miss its window of opportunity and find that it cannot sell equity securities at an attractive price or perhaps at all. If the issuer, in order to avoid this time delay, limits its purchasers to those who can purchase under a prospectus exemption and are prepared to hold the securities, it may find that the illiquidity of the securities results in a significant discount from what would otherwise be the price. Special warrant transactions do give rise to policy concerns (which are described in greater detail below), including concern that the consequences of the failure to obtain a receipt for a prospectus may not be understood by (or may be obscured from) the private placees and concern that the protections of the closed system are being circumvented because the delivery and civil liability requirements and provisions of the legislation do not directly apply in the secondary market. It was only when the Commission became convinced that this need of issuers to be able to access the capital markets on a timely basis at a guaranteed price without being subject to market risk outweigh the policy concern inherent in special warrant transactions that the Commission came to accept special warrants.[122]

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[122] See discussion in In the Matter of Med-Tech Environmental Limited (1996), 19 OSCB 2679, May 15, 1996, and In the Matter of GUARD Inc. (1996), 19 OSCB 3173 and (1996) 19 OSCB 3737, June 27, 1996.

Impediments to Reform of the Closed System

Despite the fact that many consider the closed system to have been ineffective in accomplishing its objectives, the Task Force recognizes that one should proceed with caution when recommending changes to it. The rules of the closed system have now been fully effective in Ontario since March 15, 1981. Although their original introduction caused a great deal of confusion (which continued in some cases for many years) the majority of the rules are now second nature to most of those actively involved in the investment community. There is a danger that confusion and uncertainty (with its associated costs) which resulted when the closed system was originally introduced will be replicated by significant changes to it and that the economic benefits of the change will not be worth the cost of the confusion. Secondly, and in a similar vein, almost all Canadian jurisdictions have now adopted a closed system similar or identical to that in place in Ontario. Again, when the closed system was originally introduced in Ontario numerous problems resulted from the fact that the system had not been adopted by every Canadian jurisdiction and that it was adopted on a jurisdiction-by-jurisdiction basis over a significant period of time. The need for conformity regarding the resale of securities throughout Canada is significant and the many years it has taken through amendments to the securities legislation of each province to achieve this consistency is grounds for hesitation when one considers meaningful changes to the closed system. Similarly, the closed system presently in effect in Canadian jurisdictions is compatible with the provisions of American federal and state securities laws governing resales of privately placed securities.[123] Although the systems are far from identical, both systems recognize the concept of a registered company (i.e. a reporting issuer) and both have significant restrictions on the resale of privately placed securities. Again, significant changes to the Canadian system could make it so different from the American system that the benefits of change would be impaired. Finally, a wholesale review and reformulation of the closed system would extend beyond the Task Force's mandate.

Having considered the underlying purposes of the closed system, the problems with suggesting wholesale changes to it and the difficulty of tinkering with the system, the Task Force was reluctant to suggest revisions to the hold periods. However, there was a consensus that there was little or no point in making significant changes which would tend to facilitate equity financing by SMEs unless the issue of the restrictions on resale of SME securities was addressed. Overall, the Task Force concluded that while revisions to the closed system would be best undertaken by a separate task force or in a OSC staff study directed at the closed system in its entirety, the concern that these restrictions have such an impact on financing of

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[123] The impact of Regulation S on sales of Canadian securities into the U.S. and U.S. securities into Canada, while significant, is not directly germane to this discussion.

SMEs that other recommendations would be of diminished value unless they are coupled with some changes to the hold periods caused the Task Force to determine that tinkering with the closed system offered the best prospect of allowing it to meet its objective of facilitating SME financing.

C. Recommendations for Reform

As a result, the Task Force recommends that:

1. All previously issued securities should be permitted to be qualified for distribution under a prospectus.

As noted above, securities which are subject to hold periods can only be resold either under a prospectus exemption, under a prospectus or after the expiration of the appropriate hold period. In the event that the issuer of the securities is not a reporting issuer, the hold period is permanent since it runs from the date upon which the issuer becomes a reporting issuer or the date of the initial exempt trade, whichever is later.

The Task Force believes that the liberalization of the existing restriction on qualifying previously issued securities would have a significant positive impact on SME financing, because the prospect of liquidity is crucial to attracting investment interest. The concerns sometimes expressed with the qualification of previously issued securities include: (i) hold periods protect the secondary market by ensuring that adequate information about an issuer is disseminated in the marketplace before the issuer's securities are freely tradeable; and (ii) hold periods prevent insiders of an issuer from "jumping ship" after qualification of a prospectus. Addressing the concerns set forth above, the Task Force was of the view that:

1. To the extent that the intent of the prohibition on qualifying previously issued securities was to allow time for adequate dissemination about the issue to the public market, it is clear that changes in technology have substantially sped up the dissemination of information about reporting issuers and improved its accessability. In general, the Task Force felt that it was important that information be disseminated to the media, to institutional investors and to brokerage firms who provide information to retail and institutional investors. Dissemination to the media and analysts of information regarding smaller issuers now takes at most one to two days. It was thought that it was not necessary to ensure that the information be disseminated to <u>all</u> members of the investment community because in accordance with the "efficient market theory" the price of the securities should reflect the

information available to knowledgeable players.[124] Because in conventional prospectus offerings the closing (i.e. the actual sale of the offered securities) does not occur until at least one week after the final prospectus is filed and receipted (so as to allow orders to be settled and the "cooling off" period described in Part IV.A above to lapse), the Task Force is of the view that by completion of the offering the information in the prospectus should have been adequately disseminated and absorbed by the marketplace.

2. The objective of ensuring that insiders do not abandon an issuer very shortly after a public offering, while certainly a valid objective, is better met through the imposition of an escrow and not through hold periods. The objective of "locking in" management is one of the principal theoretical underpinnings of the escrow requirement (see discussion in Part VII.A above); the mechanisms of the escrow requirement are designed to apply only to those persons whom investors have an interest in locking in (i.e. management and principal shareholders), and the very focus of the escrow requirement and its application is on when insiders should be permitted to liquidate their investments. Hold periods, by contrast, have broader objectives (as discussed above), including prevention of back door underwritings and promoting development of a public record for an issuer, and apply without discrimination to all private placees; as a tool to "lock in" management hold periods are a blunt instrument. Because hold periods are (relatively speaking) ill-suited to "lock in" insiders and because the escrow requirement is in place to do so, hold periods are therefore redundant for that purpose. The Task Force wishes to emphasize that its recommendation to permit a prospectus to qualify previously issued securities not being immediately offered for sale will <u>not</u> affect the application of the escrow requirement; shares subject to escrow, notwithstanding that they have been qualified for distribution, will not be freely tradeable until termination of the escrow.

The Task Force also recognized that it should be careful when recommending that previously issued securities be qualified for distribution under a prospectus that significant investor protections were not lost. By imposing civil liability for misrepresentations contained in the prospectus on the issuer, its selling securityholders and on its directors, chief executive officer, chief financial officer, underwriters and experts (with respect to certain portions), subject to due diligence defences for all except the issuer and selling securityholders, the *Securities Act* attempts to ensure the accuracy of the information in the

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[124] The "efficient market theory" was developed to explain the trading of securities of issuers which trade in large volume in well established markets and is arguably of substantially less relevance with respect to securities issued by SMEs. See MacIntosh Paper, at pp. 121; see also Jeffrey G. MacIntosh, "The Role of Institutional and Retail Shareholders in Canadian Capital Markets" (1994), 32 Osgoode Hall L.J. 371.

prospectus.[125] As commonly interpreted (though not clear from the language of the legislation), this liability extends only to a purchaser who purchases under the prospectus during the course of a distribution and not to a purchaser who purchases shares in a secondary market transaction at about the same time as the initial public offering. This anomaly will be reduced if the proposals in the interim report of the TSE Committee on Corporate Disclosure (and in particular the proposal that statutory civil liability extend to any person who trades in a security after a misrepresentation is made) are adopted. Investor protection concerns which have arisen in the past in connection with proposals to permit previously issued securities to be qualified for the distribution under a prospectus should be met since (i) disclosure in the prospectus will relate to the previously issued securities, (ii) this disclosure will be reviewed, and (iii) the normal civil liability provisions will apply.

In summary, the inability to sell securities for a specific time after an issuer becomes a reporting issuer or ceases to be a private company restricts promoters, employees, venture capitalists and angel investors from realizing a return on their investment when an issuer "goes public", except by way of secondary offering at the time of the initial prospectus.[126] Moreover, it results in the anomalous situation that securities can be sold under a prospectus for so long as the prospectus is kept up to date (which can be as long as one year from the date of the preliminary receipt for the prospectus) but then cannot be sold for a period of several months until the issuer has been a reporting issuer for at least 12 months.

The Task Force viewed the current requirements, insofar as they effectively prohibit the sale of securities of SMEs at any time after a prospectus has been receipted, as unduly restrictive. The Task Force felt that once an issuer has qualified securities for distribution under a prospectus its previously issued securities should be freely tradeable since there is little or no difference to a purchaser as to whether he or she acquires shares in the initial public offering or in a secondary market transaction occurring at about the same time.[127] The ability of persons (other than controlling shareholders) involved in startup financings of SMEs to freely resell their securities subject only to escrow requirements should reduce the costs and increase the availability of financing for SMEs by allowing the initial investors a more flexible exit strategy.

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[125] This issue is discussed in greater detail in Part IV.A above.

[126] There may be valid reasons why there should be restrictions on the ability of such parties to liquidate their investments, as discussed in part VII.A above, but in our view these objectives are most rationally connected to, and best met by, escrow requirements.

[127] A similar recommendation is made in the MacIntosh Paper at pp. 108-110.

The recommendations of the Task Force do not address whether or not the present requirements that controlling shareholders hold securities for specific periods of time and file notices of intention to sell should remain, as that issue should more properly be addressed in a general study of the closed system.

2. **The Director under section 61 of the *Securities Act* (or the Commission by rule) should reconsider whether or not it appears to be in the public interest to continue issuing receipts for prospectuses which qualify for distribution common shares (or other securities) to be issued upon the conversion of special warrants (or other similar convertible securities) after the other proposal described in Part IX.C.1 is implemented.**

Civil liability provisions which afford some ability to certain purchasers to rescind transactions or claim damages as a result of misrepresentations in the prospectus are viewed by many as constituting primarily a discipline on the issuer and others to ensure the accuracy of the information contained in the prospectus. Special warrants undermine this discipline since statutory remedies are available only to private placees who purchase special warrants rather than to purchasers who may acquire common shares from those persons. Private placees often have limited interest in claiming damages or rescission for misrepresentation, although they may impose other penalties such as refusing to do business with the responsible parties in the future.

By issuing special warrants an issuer can effectively create freely tradeable securities by filing a prospectus. If the *Securities Act* permits previously issued securities to be qualified for distribution under a prospectus whether or not the vendor has an immediate intention to sell those securities (as the Task Force has recommended), the need for issuers to sell special warrants should be significantly reduced.

The Task Force did not reach a consensus as to whether the regulatory concerns with respect to special warrant financings were significant enough that once its recommendation with respect to qualification of previously issued securities is adopted, the Director (or the Commission by rule) should determine that it is contrary to the public interest to issue a receipt for a prospectus which qualified securities to be issued on the conversion of special warrants. Although some members held this view, the group acknowledged that the period between the decision by a SME to sell securities and the obtaining by it of a receipt for a prospectus probably cannot be reduced to less than a month even under the Recommendation for a small public offering prospectus system. This is because the background information necessary to prepare an initial public offering prospectus is extensive. Thus, the Task Force

concluded that the issue as to whether or not special warrants should be "prohibited" is one on which it could not make a recommendation.[128]

An overall reassessment of the closed system should be commenced as soon as possible by way of an OSC staff study or by another task force.

Issues which require consideration in such a study include the following:

1. Should the basic concept of the closed system be retained, in which the securities of certain issuers which have met basic disclosure standards and continue to make specified information publicly available are freely traded and the trading of all other securities of other issuers are restricted?

2. Should the definition of "reporting issuer" be expanded to include an issuer which is a reporting issuer in any Canadian jurisdiction, an SEC registrant who filed the domestic (S series) forms or all SEC registrants including those who file foreign (F series) forms?

3. Should there be a hold period for securities acquired in a private placement transaction in order to restrict backdoor underwriting and/or provide a disincentive to private placements and an incentive to retail distribution and if so, should the hold period differ depending upon the quality of the issuer?

4. Should there be a complete restriction of sales by incorporators or underwriters except under a prospectus?

5. Should control block holders be subject to restrictions on resale and if so, should disclosure of proposed sales be sufficient or should controlling securityholders be required to hold securities for a minimum period of time?

X. SECONDARY MARKET TRADING

The Task Force recognizes that the ability of SMEs to attract equity capital is directly affected by investors' experiences (and expectations) concerning liquidity in the secondary markets. There is a range of secondary markets in which securities may trade, which for the purpose of SMEs can be broadly grouped into three segments.

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[128] See the MacIntosh Paper, pp. 128-129.

The first segment is the Canadian stock exchanges, including the TSE, the ME, the VSE and the ASE. In order to list the securities on these exchanges, an issuer must meet specified listing requirements.[129] The listing requirements generally relate to the issuer's record of earnings, tangible assets and public distribution of securities. The listing requirements for the ASE and VSE are less stringent than those of the TSE and ME. The TSE, ME, VSE and ASE have also established less onerous listing requirements which enable "junior companies" to be listed on the exchange.[130] The junior companies are, however, subject to more stringent regulatory oversight than other listed companies (for example, junior listed companies on the TSE require the exchange's pre-approval of material changes).

The second segment is comprised of American public securities markets. The National Association of Securities Dealers Automated Quotation System ("NASDAQ"), which is a quotation-based system,[131] is widely regarded as a liquid secondary market for growth companies. The NASDAQ System is subdivided into two systems, the National Market System and the SmallCap Market (the latter being the market for junior companies). The listing requirements of the NASDAQ systems and those of the TSE do not uniformly address the same considerations, making comparisons difficult. Nevertheless, it can be said (and it is generally believed) that the listing requirements of the NASDAQ National Market System generally require listed issuers to be more substantial than those of the TSE, and that the listing requirements of the NASDAQ SmallCap Market are roughly equivalent (although the parameters differ) to those of the TSE (and require listed issuers to be more substantial than those applicable to non-exempt TSE listed issuers).[132]

The third segment is CDN, which operates the unlisted equities market in Ontario and is owned by the TSE. The Task Force believes that the attractiveness and credibility of CDN, in view of its significance to SME issuers, are very important for SME capital formation. The Task Force understands that mechanisms to improve CDN market surveillance and to

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129 The listing requirements for the TSE, ME, ASE and VSE are set forth in Appendix E.

130 The listing requirements for junior industrial issuers are set forth in Appendix F. Each of the exchanges has its own terminology for junior companies: the TSE and ME refer to such companies as "non-exempt" companies; the VSE uses the term "venture" companies and lists such companies on its Venture Board; and the ASE refers to them as "junior capital pool" companies.

131 In the NASDAQ system, unlike exchanges where trades are all reported to and routed through a single trading floor, a number of market-makers handle each quoted security off the floor. The quotation system is akin to a bulletin board posting current bid and ask prices for each market maker in addition to information concerning completed trades.

132 The listing requirements of the NASDAQ National Market and Small Cap Domestic Market are set forth in Appendix G.

improve the trade reporting systems have been and are continuing to be implemented in CDN. CDN has, in our view, also suffered because of uncertainty as to its role, particularly because of the wide range of trading activities in that market. CDN considers that its mission is to provide an efficient, visible and fair secondary market that facilitates capital formation for SMEs. We understand that CDN is working on a strategic plan for future development of its system and market and that it plans to introduce further initiatives which will increase its visibility and continue to foster credibility and confidence among investors. The Task Force encourages the efforts to continue to strengthen the regulation of CDN. While we recognize that some commentators believe that the key to facilitating the raising by SMEs of equity in Ontario is the development of a strong secondary market under the auspices of CDN or the TSE (these suggestions range from the upgrading of CDN to a full exchange to the creation of a new tier for SME issuers), we are concerned that this proposition is too simplistic a solution. In our collective experience, markets do not create trading; rather, trading activity creates markets. Efforts to promote and enhance CDN cannot in and of themselves create a liquid secondary market for securities of SMEs if basic economics dictate otherwise. In addition, given the relatively small size of the Canadian market, questions remain as to the desirability of promoting several Canadian venture capital exchanges. When assessing the proper role for CDN, we feel that both its potential economic benefits to Ontario companies and securities market participants and the role of the VSE and ASE should be considered.

We make no specific recommendations concerning the future of CDN, nor any comments concerning recommendations made by various commentators to lower the listing requirements of the TSE or to create a second tier of trading on the TSE,[133] as those issues are the responsibility of and are being dealt with by the TSE. Our leaving these issues to be dealt with first by the TSE is not in any way based upon our lack of recognition of their importance to facilitating the raising of equity by SMEs. The Task Force recognizes that few investors will be interested in buying securities unless there is a reasonable prospect of profit from resale. It is because of the significance of secondary market trading activity that the Task Force felt that the issue would be best first addressed by those who are primarily involved in this activity. Of course, all proposals of the TSE concerning changes to CDN are subject to Commission oversight. By not making specific recommendations, the Task Force is in no way suggesting that the OSC should not have a primary role in regulating secondary trading of SME securities; it has and will continue to have that responsibility both through its direct regulatory role and through its oversight of the TSE.

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[133] See discussion in the MacIntosh Paper at pp. 137-140.

XI. SECTORAL STRATEGIES

Financing requirements for issuers under the existing regulatory regime vary to a certain extent depending on the particular issuer's industry sector. The most notable example of sector-specific financing requirements is OSC Policy 5.2, which outlines the financing requirements for junior natural resource issuers. OSC Policy 5.2 prescribes the escrow requirements for offerings by junior natural resource issuers, consideration for acquisition of resource properties, and limits on dealer compensation, management remuneration and private placements, among other things. A second notable example of financing requirements which are not universally applicable across all industry sectors is the "government incentive securities" private placement exemption described in Part IV.A.3 above, which permits prospectus exempt offerings of securities which qualify for government tax or financial incentives, such as the scientific research tax credit.

The Task Force is of the view that financing requirements should not vary based upon an issuer's industry, for two reasons. First, the Task Force believes that securities regulatory requirements should not be used to further collateral government policy initiatives. For example, in the Task Force's view, investors need as much information about tax shelter investments which might qualify for the "government incentive securities" prospectus exemption[134] as about non-tax shelter investments, and may in fact require greater disclosure because the favourable tax treatment may tend to cause investors to focus less attention on the fundamental attributes of the investment itself. Secondly, and perhaps more importantly, the Task Force believes that in formulating securities regulatory requirements, there is no longer a need to develop sector-specific regulatory regimes. For example, to the extent that OSC Policy 5.2 was developed to curtail inappropriate sales practices of securities dealers, the Task Force believes that inappropriate sales practices should be the subject of enforcement or rule-making proposals specifically directed at such sales practices. The Task Force also notes that the differential treatment for resource issuers is not currently facilitating a significant amount of economic activity in Northern Ontario, as evidence reviewed suggests that much of the capital raised under the policy was being raised for foreign-based resource projects.

Accordingly, the Task Force proposes that sector-specific components of the existing regulatory regime, such as OSC Policy 5.2, be repealed. The Task Force believes that there is no reason why a resource-based issuer should not use the small public offering system described in Part V of this Report or be subject to other related rules on the same basis as issuers in other industries, as the Task Force can see no clear basis upon which to distinguish

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134 Subsection 14(f) of the Regulation. See Part IV.A.3 above.

between a resource company with an unexplored property and a bio-technical company with an unproven pharmaceutical product.

In addition, subject to the comments made in Part II.F of this Report, the Task Force is not aware of any compelling reason why any SME issuer, no matter which sector it operates in, should not be able to utilize the closely-held business issuer and accredited investor exemptions proposed herein.

APPENDIX A

COMMENTS RECEIVED IN RESPONSE TO PROPOSAL FOR COMMENT

(Where comments received were expressed as the comments of an institution or firm, those comments are attributed to the institution or firm with the authors' name(s) in parentheses, except in the case of comments by regulators. Where the comments are expressed as personal comments, they are attributed to the author with the author's institution (where applicable) in brackets.)

Aird & Berlis (Jay A. Lefton)
Alberta Securities Commission
Baker & McKenzie (Toronto) (M. Marlene Atlas)
BDO Dunwoody (Toronto) (Maria V. Casano)
Borden & Elliot (Paul G. Findlay)
Bradley W. Ashley (PRIVEQ Financial Corporation)
British Columbia Securities Commission
Business Centurions (Donald Hillhouse, A. George Fells)
Cally Jordan
Canadian Bar Association - British Columbia Branch (David Jennings)
Canadian Bankers Association (Susan Cantlie)
Canadian Bar Association - Ontario (Securities Law Sub-Committee of the CBAO Business Law Section)
Chartered Accountants of Ontario (Douglas J. Low)
David Holden (Fairview Management Corporation)
Doug Jones (Business Funding Group Inc.)
Doug Montgomery (Ernst & Young (Waterloo))
Financial Executives Institute Canada (Mark Walsh)
Fraser & Beatty (Vancouver) (British Columbia Securities Club)
Harry T. Seymour
Jacques Sayegh (Royal Bank Capital Corporation)
John Heaven (Telepanel)
Joseph De Felice
KPMG (Toronto)
LinkAge Management Inc.
McCarthy Tétrault (Toronto) (Michael C. Nicholas)
Ministry of Economic Development, Trade and Tourism (Ontario)
Ministry of Environment and Energy (Ontario) (Nora Gurland)
North York Chamber of Commerce (Wayne Owens and W.A.D. Selby)
Nova Scotia Securities Commission
Ontario Securities Commission (Enforcement Branch)
Ottawa-Carleton Economic Development Corporation (Frederick Abboud)

Prospectors and Developers Association of Canada (John A. Hansuld)
Prospectors and Developers Association of Canada (Securities Committee)
Rob Wildeboer (Wildeboer Rand Thomson Apps)
Rolland Russell Martel (Russell Martel)
Sharwood and Company (Gordon R. Sharwood)
Simon Romano (Special Counsel, Ontario Securities Commission)
T.A. Houston (Fraser & Beatty (Toronto))
The Toronto Stock Exchange
Tory Tory DesLauriers & Binnington (Heather G. Crawford)
Vancouver Stock Exchange
VentureLinix Corporation (Jack D. Nolan)
Walter H. Thompson
York Technology Association (M. Scott MacCannell)

APPENDIX B

SELECTIVE BIBLIOGRAPHY

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APPENDIX C

SOURCES OF CAPITAL

All section references are references to sections of the *Securities Act* (Ontario) (the "Act") other than references to sections of the Regulations, which refer to provisions of the Regulations under the Act.

Source	*Securities Act* (Ontario)		Task Force Recommendation	
	Provision	Requirement/Exemption	Paragraph	Recommendation
1. "Love Money"	(i) s.73(1)(a) and s.35(2)10	Private Company Exemption	IV.C.1	Closely-held Business Issuer Exemption
			- and -	
			IV.C.2	Information Statement
2. The "Angel" Market	(i) s.73(1)(a) and s.35(2)10	Private Company Exemption	IV.C.1	Closely-held Business Issuer Exemption
	- or -		- and -	
	(ii) s.72(1)(d) and s.27(1) of the Regulations	$150,000 Exemption	IV.C.2	Information Statement
	- or -		- or -	
	(iii) s.72(1)(p)	Seed Capital Exemption	I.V.C.3	Accredited Investor Exemption
	- or -			
	(iv) s.14(f) of the Regulations	Government Incentive Securities Exemption		
3. Formal Venture Capital Market	(i) s.72(1)(a)	Prescribed Institution Exemption	IV.C.3	Accredited Investor Exemption
	- or -			
	(ii) s.72(1)(c)	Exempt Purchaser Exemption		

Source	*Securities Act* (Ontario)		Task Force Recommendation	
	Provision	Requirement/Exemption	Paragraph	Recommendation
	- or -			
	(iii) s.72(1)(d) and s.27(1) of the Regulations	$150,000 Exemption		
	- or -			
	(iv) s.72(1)(p)	Seed Capital Exemption		
	- or -			
	(v) s.14(f) of the Regulations	Government Incentive Securities Exemption		
4. Institutional Private Placement	(i) s.72(1)(a)	Prescribed Institution Exemption	IV.C.3	Accredited Investor Exemption
	- or -			
	(ii) s.72(1)(c)	Exempt Purchaser Exemption		
	- or -			
	(iii) s.72(1)(d) and s.27(1) of the Regulations	$150,000 Exemption		
	- or -			
	(iv) s.72(1)(p)	Seed Capital Exemption		
	- or -			
	(v) s.14(f) of the Regulations	Government Incentive Securities Exemption		
5. Public Equity Markets	(i) s.53(1)	Prospectus Filing	V.B.1	Small Business Prospectus Form

Source	*Securities Act* (Ontario)		Task Force Recommendation	
	Provision	Requirement/Exemption	Paragraph	Recommendation
6. Trade Partners	(i) s.73(1)(a) and s.35(2)10	Private Company Exemption	IV.C.1	Closely-held Business Issuer Exemption
	- or -		- and -	
	(ii) s.72(1)(d) and s.27(1) of the Regulations	$150,000 Exemption	IV.C.2	Information Statement
	- or -		- or -	
	(iii) s.72(1)(p)	Seed Capital Exemption	I.V.C.3	Accredited Investor Exemption
	- or -			
	(iv) s.14(f) of the Regulations	Government Incentive Securities Exemption		

APPENDIX D

NASAA INFORMATION STATEMENT

A CONSUMERS GUIDE TO SMALL BUSINESS INVESTMENTS

State laws have been relaxed to make it easier for small businesses to raise start-up growth financing from the public. Many investors view this as an opportunity to "get in on the ground floor" of emerging businesses and to "hit it big" as these small businesses grow into large ones.

Statistically, most small businesses fail within a few years. Small business investments are among the most risky that investors can make. This guide suggests items to consider for determining whether you should make a small business investment.

Risks and Investment Strategy

A basic principle of investing in a small business is: **NEVER MAKE A SMALL BUSINESS INVESTMENT THAT YOU CANNOT AFFORD TO LOSE ENTIRELY**. Never use funds that might be needed for other purposes, such as college education, retirement, loan repayment or medical expenses. Instead use funds that would otherwise be used for a consumer purchase, such as a vacation or a downpayment on a boat or RV.

Above all, never let a commissioned securities salesperson or an officer or director of a company convince you that the investment is not risky. Any such assurance is almost always inaccurate. Small business investments are generally highly illiquid even though the securities may technically be freely transferable. Thus, you will usually be unable to sell your securities if the company takes a turn for the worse.

Also, just because the state has registered the offering does not mean the particular investment will be successful. The state does not evaluate or endorse the investment. (If anyone suggests otherwise to you, it is unlawful.)

If you plan to invest a large amount of money in a small business, you should consider investing smaller amounts in several small businesses. A few highly successful investments can offset the unsuccessful ones. Even when using this strategy, **DO NOT INVEST FUNDS YOU CANNOT AFFORD TO LOSE ENTIRELY**.

Analyzing the Investment

Although there is no magic formula for making successful investment decisions, certain factors are often considered particularly important by professional venture investors. Some questions to consider are as follows:

1. How long has the company been in business? If it is a start up or has only a brief operating history, are you being asked to pay more than the shares are worth?

2. Consider whether management is dealing unfairly with investors by taking salaries or other benefits that are too large in view of the company's stage of development or by retaining an inordinate amount of the equity of the company compared with the amount investors will receive. For example, is the public putting up 80% of the money but only receiving 10% of the company shares?

3. How much experience does management have in the industry and in a small business? How successful were the managers in previous businesses?

4. Do you know enough about the industry to be able to evaluate the company an d make a wise investment?

5. Does the company have a realistic marketing plan and do they have the resources to market the product or service successfully?

There are many other questions to be answered, but you should be able to answer these before you consider investing.

Making Money on your Investment

The two classic methods for making money on an investment in a small business are resale in the public securities markets following a public offering and receiving cash or marketable securities in a merger or other acquisition of the company.

If the company is the type that is not likely to go public or be sold out within a reasonable time (i.e., a family owned or closely held corporation), it may not be a good investment for you irrespective of its prospects for success because of the lack of opportunity to cash in on the investment. Management of a successful private company may receive a good return indefinitely through salaries and bonuses but it is unlikely that there will be profits sufficient to pay dividends commensurate with the risk of the investment.

Other Suggestions

The Disclosure Document usually used in public venture offerings is the "Form U-7", which has a question and answer format. The questions are designed to bring out particular factors that may be crucial to the proper assessment of the offering. Read each question and answer carefully. If an answer does not adequately addresses the issues raised by the question, reflect on the importance of the issue in the context of the particular company.

Even the best venture offerings are highly risky. If you have a nagging sense of doubt, there is probably a good reason for it. Good investments are based on sound business criteria and not emotions. If you are not entirely comfortable, the best approach is usually not to invest. There will be many other opportunities. Do not let a securities salesperson pressure you into making a premature decision.

It is generally a good idea to see management of the company face-to-face to size them up. Focus on experience and track record rather than a smooth sales presentation. If at all possible, take a sophisticated business person with you to help in your analysis.

Beware of information that is different from that in the Disclosure Document or not contained in the Disclosure Document. If it is significant, it must be in the Disclosure Document or the offering will be illegal.

Conclusion

Greater numbers of public investors are "getting in on the ground floor" by investing in small businesses. When successful, these enterprises enhance the economy and provide jobs for its citizens. They can also provide new investment opportunities, but that must be balanced against the inherently risky nature of small business investments.

In considering a small business investment, you should proceed with caution, and above all, never invest more than you can lose.

APPENDIX E
MINIMUM LISTING REQUIREMENTS FOR INDUSTRIAL ISSUERS

	Toronto Stock Exchange	Montreal Stock Exchange	Alberta Stock Exchange	Vancouver Stock Exchange
1. **Financial**	**s.309** (v) net tangible assets of $5,000,000*; (vi) earnings of at least $200,000, before taxes and extraordinary items, in the fiscal year immediately preceding the filing of the listing application; (vii) pre-tax cash flow of $500,000 in the fiscal year immediately preceding the filing of the listing application; and (viii) adequate working capital and capitalization to carry on the business. It is recognized that there may be exceptional circumstances to justify the granting of an exemption from section 19.09, in which case the application will be considered on its own merits. "Exceptional circumstances" for this purpose will normally be confined to an affiliation with a substantial established enterprise and/or an exceptionally strong financial position.	**art.9053(1.2)** (a) Minimal tangible net worth of $3,500,000. Consideration will be given to permit the inclusion of deferred development charges or other intangible assets in the calculation of tangible net worth if, in the opinion of the Exchange, the circumstances so warrant. (b) Net income of at least $200,000 before taxes in the last fiscal year. In applying these standards, the Exchange may exclude income which (i) is essentially non-recurring (whether or not designated as an extraordinary item), (ii) results from discontinued operations, or (iii) gives effect to accounting changes. (c) Pre-tax cash flow of $500,000 in the last fiscal year.	s.3.1 **Industrial Companies with a Record of Earnings** 3.1.1 **Net Tangible Assets** A minimum of $400,000. 3.1.2 **Working Capital** Shall be adequate to carry on the business. 3.1.3 **Earnings** Net income before extraordinary items of at least $50,000 after all charges including income taxes in the fiscal year immediately preceding the filing of the listing application or a minimum average net income of $50,000 after all charges including income taxes for two of the last three fiscal years. s.3.2 **Industrial Companies with No Record of Earnings** 3.2.1 **Property** The Company must have a working commercial	**s.1.3.3(a) Without a History of Earnings** The company must: (i) have net tangible assets of $3,000,000; (ii) provide evidence satisfactory to the Exchange, indicating a reasonable likelihood of future profitability; and (iii) have adequate working capital and financial resources to carry on the business. **s.1.3.3(b) With a History of Earnings** The Company must: (i) have net tangible assets of $900,000; (ii) have earnings of at least $100,000, before income taxes and extraordinary items, in the immediately preceding fiscal year; and (iii) have adequate working capital and financial resources to carry on the business.

	Toronto Stock Exchange	Montreal Stock Exchange	Alberta Stock Exchange	Vancouver Stock Exchange
	NOTE: An applicant who meets the criteria set out above will be exempted from the requirements of s.19.09 of the TSE's General By-Law which requires listed companies to obtain prior TSE acceptance for filing of all proposed material changes, including changes which do not entail an issuance of securities.	(d) Adequate working capital and capitalization to carry on its business. Companies which comply with the criteria set out above will be exempted from paragraph (b) of article 9153 of the Rules of the Exchange for Industrial, Financial and Real Estate Companies which provides that a listed company shall not proceed with a proposed material change until the Exchange has accepted notice of such material change for filing.	prototype of its product at the time of the filing of the listing application. A minimum of $250,000 in development expenses or such amount as the Exchange may determine must have been expended on development of the applicant's products or business in the previous 5 years. In determining deferred development expenses, the value of general and administrative expenses and managerial fees will be excluded. **3.2.2. Net Tangible Assets** A minimum of $400,000. **3.2.3 Working Capital** Shall be adequate to carry out the programme outlined in its management plan and have a minimum of $100,000 in unallocated funds. **3.2.4 Supporting Reports** 3.2.4.1. The company shall have a management plan outlining the development of its business for a period of 24 months. The management	**NOTE:** The applicant company must also comply with the minimum listing requirements set forth on Appendix E for junior applicant companies.

	Toronto Stock Exchange	Montreal Stock Exchange	Alberta Stock Exchange	Vancouver Stock Exchange
			plan must demonstrate that the product, service or technology is sufficiently developed and that there is a reasonable expectation of earnings from its business within the period of the management plan. 3.2.4.2. The Exchange may require that an independent and qualified consultant provide an assessment of the management plan. 3.2.4.3. Where a company has no history of operations, the Company shall submit a feasibility study prepared in accordance with Circular No. 12.	

	Toronto Stock Exchange	Montreal Stock Exchange	Alberta Stock Exchange	Vancouver Stock Exchange
2. Distribution	**s.310** At least 1,000,000 freely-tradeable shares having an aggregate market value of $2,000,000 must be held by at least 300 public holders, each holding one board lot or more. In circumstances where public distribution is achieved other than by way of a public offering, e.g., by way of a reverse take-over, share exchange offer or other distribution, the Exchange may require evidence that a satisfactory market in the company's securities will develop. Prior trading on another market or sponsorship by an Exchange member, which will assist in maintaining an orderly market, may satisfy this condition.	**art.9053** (d) A minimum market value of $1,000,000 of publicly held shares which must be free of any trading restrictions. (e) A minimum of 1,000,000 publicly held securities which must be free of any trading restrictions. **art.9052** (c) A minimum of 300 public holders must each hold at least one board lot of shares free of any trading restrictions.	**s.3.7** A minimum of 500,000 of the issued shares shall be free of any trading restrictions and held by at least 300 public shareholders each holding a board lot or more. In addition, at least 20% of the issued and outstanding shares must be free trading and held by the public shareholders. The Exchange may consider listing companies that have between 200 and 300 public shareholders each holding a board lot or more if the company has more than 400 public shareholders in total. The Exchange will consider listing companies which have only 200 public shareholders each holding a board lot where, in conjunction with the listing, the company completed a prospectus offering having an offering price of at least $2.00 per share. **s.3.8 Market Value of Issued Shares in the Hands of the Public** A minimum of $400,000.	**s.1** There must be at least 1,000,000 freely-tradeable shares having an aggregate market value of $1,800,000, held by at least 300 public shareholders, each holding one board lot or more.

	Toronto Stock Exchange	Montreal Stock Exchange	Alberta Stock Exchange	Vancouver Stock Exchange
3. **Management**	**s.311** The management of an applicant company shall be an important factor in the consideration of a listing application. In addition to the factors set out in Section 325, the Exchange will consider the background and expertise of management in the context of the business of the company.	**art.9052** (a) The Exchange must be satisfied as to the integrity, financial responsibility and competence of the management and of the principal shareholders of an applicant company before a listing will be granted. See Policy I-13.	**s.2.3** 2.3.1 The management of an applicant company shall be an important factor in determining whether or not a listing application shall be granted. 2.3.2 The applicant company must be managed by individuals who have expertise, or the applicant company must have retained a consultant who has expertise, in the area of the company's actual or proposed undertaking. 2.3.3 One or more of the directors or officers must have public company experience. 2.3.4 Management must devote a sufficient amount of their time to the affairs of the company. With respect to companies other than junior capital pool companies, the Exchange will normally require the company has at least one full time officer.	**Rule B 1.11** The applicant company must be managed by individuals who have expertise or the applicant must have retained a consultant who has expertise in the area of the company's actual or proposed undertaking. **Rule B 1.12** 3. The applicant company must have: (a) a management plan which shall be in respect of a period of at least one year in length, for the orderly development of its business; (b) a report, which the Exchange may require be prepared by an independent and qualified consultant, detailing the financial requirements of the applicant company for the period covered by the management plan; (c) where the applicant company is proposing to develop a product or service, a feasibility report, prepared by a qualified and independent consultant, specifically detailing the demand for the applicant company's

	Toronto Stock Exchange	Montreal Stock Exchange	Alberta Stock Exchange	Vancouver Stock Exchange
				proposed product or service and the economic viability of the applicant company's proposed product or service; (d) where the applicant company is proposing to produce a product, a product which will be capable of being economically produced within the period covered by the management plan referred to in subparagraph (a) above; (e) the report referred to in subparagraph (b) above, must outline, in detail, the operating expenditures required by the issuer and demonstrate that the issuer has sufficient funds to cover the expenditures contained in the management plan for at least the initial operating period of six months from the date of listing.

* Consideration will be given to permitting the inclusion of deferred development charges or other intangible assets in the calculation of net tangible assets if, in the opinion of the Exchange, the circumstances so warrant.

APPENDIX F
MINIMUM LISTING REQUIREMENTS FOR JUNIOR (NON-EXEMPT) INDUSTRIAL ISSUERS

	Toronto Stock Exchange	Montreal Stock Exchange	Alberta Stock Exchange	Vancouver Stock Exchange
1. Financial	**s.309** **(a)** (i) net tangible assets of $1,000,000*; (ii) earnings of at least $100,000 before taxes and extraordinary items, in the fiscal year immediately preceding the filing of the listing application; (iii) pre-tax cash flow of $400,000 in the fiscal year immediately preceding the filing of the listing application; and (iv) adequate working capital and capitalization to carry on the business; OR **(b)** (i) net tangible assets of $5,000,000*; (ii) evidence, satisfactory to the Exchange, indicating a reasonable likelihood of future profitability**; and	**art.9053(1.1)** (a) Minimum tangible net worth of $1,000,000; and (b) Net income of at least $100,000 before taxes in the fiscal year immediately preceding the filing of the listing application and a minimum of two of the last three years must have been profitable; In applying these standards, the Exchange may exclude income which (i) is essentially non-recurring (whether or not designated as an extraordinary item); (ii) results from discontinued operations; or (iii) gives effect to accounting changes.	**s.7.1** A minimum of $100,000 in cash shall have been contributed by the officers and directors and their associates and affiliates, prior to the public offering of shares. The minimum price at which shares may be issued prior to the public offering is 50% of the public offering price. **s.7.3** A maximum gross amount of $500,000 may be raised prior to listing including funds raised prior to the public offering and the proceeds of the public offering. The gross proceeds from the public offering must be a minimum of $200,000 and a maximum of $300,000.	**Rule B 1.13** **s.1(b)** The applicant company must have expended a minimum of $300,000 on account of business development expenditures. Issuers may be required to demonstrate that the prior expenditures of $300,000 relate to the development of its property or business and have resulted in an increase in value. **s.2** The minimum price per share at which the applicant company's "seed capital" shares were sold must have been equal to, or greater than, $0.25. **s.3** The minimum amount of the total funds raised by the applicant company, by way of the issuance of its "seed capital" shares, must have been equal to, or greater than, $400,000. **s.4** The minimum price, net to the applicant company's treasury, at which the applicant company's securities were issued during

	Toronto Stock Exchange	Montreal Stock Exchange	Alberta Stock Exchange	Vancouver Stock Exchange
	(iii) adequate working capital and capitalization to carry on the business, OR **(c)** (i) earnings of at least $200,000, before taxes and extraordinary items, in the fiscal year immediately preceding the filing of the listing application; (ii) pre-tax cash flow of $500,000 in the fiscal year immediately preceding the filing of the listing application; and (iii) adequate working capital and capitalization to carry on the business.	If an applicant company operates substantially in Canada, the Exchange may exempt such company from earnings requirements provided evidence, satisfactory to the Exchange, indicates a reasonable likelihood of future profitability. Such applicant shall file a complete financial forecast accompanied by the independent auditor's report. The Exchange may also require the filing of a copy of any contract entered into by the issuer. In reviewing such applications, the Exchange will attach additional weight to the quality of the company's management and to its sponsorship. (c) Adequate working capital and capitalization to carry on its business.		its first primary distribution to the public must have been equal to, or greater than, $0.30 per share in the case of shares or $0.40 per unit in the case of units. **s.5** The combined minimum net proceeds to the treasury of the applicant company which resulted from the issuance of its "seed capital" shares and the issuance of its securities sold during its first distribution by prospectus offering must have been equal to, or greater than, $850,000. **Rule B 1.12** 5. The applicant company must have a minimum of the greater of $100,000 or sufficient funds to cover the expenditures contained in a business plan covering an initial operating period of six months.
2. Distribution	**s.310** At least 1,000,000 freely-tradeable shares having an aggregate market value of $2,000,000 must be held by at least 300 public holders, each holding one board lot or more.	**art.9053** (d) A minimum market value of $1,000,000 of publicly held shares which must be free of any trading restrictions. (e) A minimum of 1,000,000 publicly held securities which must be free of any trading restrictions.	**s.7.2** A minimum of 1,000,000 of the issued shares shall be free of any trading restrictions and held by at least 300 public shareholders each holding a board lot or more. The maximum purchase by any single shareholder purchasing in the public distribution shall be 2% of the number of shares being distributed to the public.	**Rule B 1.11** The applicant company must have issued at least 600,000 shares in its IPO with at least 300,000 of them free of resale restrictions and held by at least 300 public shareholders - each holding the minimum purchase lot size.

	Toronto Stock Exchange	Montreal Stock Exchange	Alberta Stock Exchange	Vancouver Stock Exchange
	In circumstances where public distribution is achieved other than by way of a public offering, e.g., by way of a reverse take-over, share exchange offer or other distribution, the Exchange may require evidence that a satisfactory market in the company's securities will develop. Prior trading on another market or sponsorship by an Exchange member, which will assist in maintaining an orderly market, may satisfy this condition.	**art.9052** (c) A minimum of 300 public holders must each hold at least one board lot of shares free of any trading restrictions.		

	Toronto Stock Exchange	Montreal Stock Exchange	Alberta Stock Exchange	Vancouver Stock Exchange
3. Management	**s.311** The management of an applicant company shall be an important factor in the consideration of a listing application. In addition to the factors set out in Section 325, the Exchange will consider the background and expertise of management in the context of the business of the company.	**art.9052** (a) The Exchange must be satisfied as to the integrity, financial responsibility and competence of the management and of the principal shareholders of an applicant company before a listing will be granted. See Policy I-13.	**s.2.3** 2.3.1 The management of an applicant company shall be an important factor in determining whether or not a listing application shall be granted. 2.3.2 The applicant company must be managed by individuals who have expertise, or the applicant company must have retained a consultant who has expertise, in the area of the company's actual or proposed undertaking. 2.3.3 One or more of the directors or officers must have public company experience. 2.3.4 Management must devote a sufficient amount of their time to the affairs of the company. With respect to companies other than junior capital pool companies, the Exchange will normally require the company has at least one full time officer.	**Rule B 1.11** The applicant company must be managed by individuals who have expertise or the applicant must have retained a consultant who has expertise in the area of the company's actual or proposed undertaking. **Rule B 1.12** 3. The applicant company must have: (a) a management plan which shall be in respect of a period of at least one year in length, for the orderly development of its business; (b) a report, which the Exchange may require be prepared by an independent and qualified consultant, detailing the financial requirements of the applicant company for the period covered by the management plan; (c) where the applicant company is proposing to develop a product or service, a feasibility report, prepared by a qualified and independent consultant, specifically detailing the demand for the applicant company's proposed product

	Toronto Stock Exchange	Montreal Stock Exchange	Alberta Stock Exchange	Vancouver Stock Exchange
				or service and the economic viability of the applicant company's proposed product or service; (d) where the applicant company is proposing to produce a product, a product which will be capable of being economically produced within the period covered by the management plan referred to in subparagraph (a) above; (e) the report referred to in subparagraph (b) above, must outline, in detail, the operating expenditures required by the issuer and demonstrate that the issuer has sufficient funds to cover the expenditures contained in the management plan for at least the initial operating period of six months from the date of listing.

* Consideration will be given to permitting the inclusion of deferred development charges or other intangible assets in the calculation of net tangible assets if, in the opinion of the Exchange, the circumstances so warrant.

** As a general guideline, applicants should file a complete set of forecast financial statements which should be accompanied by an independent auditor's opinion following the CICA Auditing Guideline and which should forecast pre-tax cash flow and earnings from operations for the next fiscal year, at the levels set out under paragraph (a). The financial statements of the applicant should include gross revenues from operations for at least the last six months and, at least on a pro forma basis, should reflect sufficient working capital and/or cash flow to meet the forecasts.

APPENDIX G

INITIAL LISTING REQUIREMENTS OF NASDAQ

SMALLCAP MARKET

Total assets	$4 million
Total stockholders' equity	$2 million
Registration under Section 12(g) of the Securities Exchange Act of 1934 or equivalent[1]	Yes
Public float (shares)[2]	100,000
Market value of public float	$1 million
Shareholders	300
Minimum bid price	$3
Number of market makers	2

(above figures in U.S. Dollars)

1 A temporary, automatic exemption exists for initial public offerings.

2 Public float is defined as shares that are not "held directly or indirectly by any officer or director of the issuer and by any person who is the beneficial owner of more than 10 percent of the total shares outstanding..."

NASDAQ NATIONAL MARKET

	Alternative 1	Alternative 2
Registration under Section 12(g) of the Securities Exchange Act of 1934 or equivalent	Yes	Yes
Net Tangible Assets[1]	$4 million	$12 million
Net Income (in latest fiscal year or 2 of last 3 fiscal years)	$400,000	N/A
Pretax Income (in latest fiscal year or 2 of last 3 fiscal years)	$750,000	N/A
Public Float (Shares)[2]	500,000	1 million
Operating History	N/A	3 years
Market Value of Float	$3 million	$15 million
Minimum Bid Price	$5	$3
Shareholders		
- if between 0.5 and 1 million shares publicly held	800	400
- if more than 1 million shares publicly held	400	400
- if more than 0.5 million shares held and average daily volume in excess of 2,000 shares	400	400
Number of Market Makers	2	2

1 Net Tangible Assets means total assets (excluding goodwill) minus total liabilities.

2 Public float is defined as shares that are not "held directly or indirectly by any officer or director of the issuer and by any person who is the beneficial owner of more than 10 percent of the total shares outstanding..."